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THE JOURNAL OF Taxation

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What would you say if your own T&E expenses were under attack? A serious drama

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

What would you say if your own T & E expenses were under attack? A serious drama

by RICHARD D. HOBBET *and* ROGER L. BOERNER

Good fiction sometimes portrays real life problems better than facts. So it is with a conference with a revenue agent. The drama which follows concerns a lawyer whose travel and entertainment expenses ($10,000) are under attack from an agent. This "verbatim" transcript of the conference illustrates the operation of most of the law and cases involved, plus adding the arguments, pro and con, which might (and probably would) be used in such a case. This dialogue was written and presented by the authors at a recent meeting of the Milwaukee Bar Association. Reports from Milwaukee indicate that the audience thought the play both amusing and serious, but more helpful than funny.

THE SCENE opens in a conference room in the office of the District Director, Internal Revenue Service, Milwaukee. As the curtain goes up, we see Jack Hitax, a revenue agent, seated at the left side of a plain table. The room is unadorned except for a small picture frame, backstage center, containing an engrossed motto reading "In God We Trust."

Time: February, 1960.

Enter J. Stainless Steel, an attorney practicing in Milwaukee.

J.S.S.: Mr. Hitax, I am J. Stainless Steel, Esq. I understand that we have an appointment to go over some information you want in connection with my 1958 return.

J.H.: That is right, Mr. Steel; please sit down. I have your file here. Let us start right out with the first item checked on the letter you received — that is, entertainment and promotional expenses. At line 21 of your Schedule C, I see that you deducted over $10,000 for entertainment expenses. Would you mind giving me a breakdown of how you arrived at this figure.

J.S.S.: Well, sir, I have always believed that promotional activities are important to my law practice. I do a great variety of things to make myself known, enhance my reputation and secure new clients (or retain the few I already have). All of these activities are deductible under Code Sections 62 and 162. Let's start out with meals. I spent $1,000 on meals for clients or prospective clients at the various clubs to which I belong, at my home and at conventions. This, of course, includes a few drinks.

J.H.: Does it also include any meals for you and your wife?

J.S.S.: Sure. My meals are included and in some cases those of my wife. Sometimes the only way to handle the situation was to include my wife in the party. Where this was true I have included her meals; they were a necessary business expense.

J.H.: Do these clients ever return the favor?

J.S.S.: Yes, I try to keep fairly even with them. Sometimes I do this on a large scale at home. For example, in December of this year I gave a large party, the expenses of which I have itemized here. I have kept a similar list of other meals although I don't seem to have written all of them down. About $300 worth of this I know I spent but I cannot put my finger on exactly where.

J.H.: Most of the people you invited were friends weren't they, Mr. Steel? Aren't you really talking about your social life; about the personal expenses which you would have incurred at clubs and at your home whether or not you were a lawyer? Section 262 says that these are not deductible. Doesn't the fact that your clients reciprocate in entertaining you indicate that your expense is more personal than business?

J.S.S.: Not at all. The social contact which I have with them exists for business purposes. When I entertain a client or prospective client, I seek to develop a relationship which will cause him to initiate social contacts with me. It's this type of relationship that fosters my business. My business is served as well by contacts with my clients in their homes as in my own. Don't forget that my motive isn't changed a bit by the fact they may sometimes wish to entertain me.

J.H.: It seems to me that what you're really saying is that this social contact is building goodwill. That is in the nature of a capital expense for which you have no authority to take a deduction.[1]

J.S.S.: I beg your pardon, but this ought to be a very simple, practical matter. I claimed this deduction from gross income under Section 62 and Section 162. These sections permit me to deduct all of the ordinary and necessary expenses of carrying on a trade or business. Expenses for the entertainment of clients are certainly *usual* for attorneys and they are, therefore, *"ordinary."*[2] Such expenses are certainly helpful and appropriate to securing clients and, therefore, they are "necessary."[3] The fact that I incidentally enjoy myself does not make an activity which is necessary to producing business any less deductible.

J.H.: I agree that your enjoyment is not relevant to the question of deducting the expenses. You have to prove that there is a direct relationship between the expense and the production of income. You just haven't shown me that these meals and drinks either helped you get a client or keep one. The burden of proof is on you to show that the expenses are not personal.

J.S.S.: Everyone knows that entertaining clients with food and drink is an accepted part of practicing law and that it is necessary. You're just naive if you don't accept this.

J.H.: The Tax Court apparently doesn't accept it. Recently, in the

Lorenz[4] case, it refused to take judicial notice that it is advisable for an attorney to entertain clients from time to time.

J.S.S.: The court's refusal to take judicial notice only means it is not a matter of public knowledge. You might look at the *Young*[5] case. Young was a lawyer who claimed a deduction for the expense of operating his home because he saw clients there, and, what's more, the Commissioner allowed the deduction. Maybe I haven't gone far enough in deducting this type of expense.

J.H.: Yes, but the expense allowed by the Tax Court in that case was a portion of the expense of a house which the lawyer used partially as a second office. That doesn't mean you can deduct part of the household operating expenses as an entertainment expense just because you entertain clients in your home.

J.S.S.: I haven't claimed *any* of the expenses of my home as deductible entertainment expenses. The expenses I have here for entertaining in my home are just the actual costs of giving that one large houseparty in December. I had an orchestra, barmaid, etc., just for that occasion.

J.H.: How did that party generate any business for your law practice?

J.S.S.: At least four persons present were important clients of mine. One fellow was a fraternity brother of mine that I'd very much like to have as a client.

J.H.: I suppose by the same token, when your daughter is married you'll deduct the cost of her wedding and reception because you invite some clients to the affair.

J.S.S.: That's different. That expense would be one incurred principally for personal reasons. However, I *had* to give this party to continue a relationship which I consider absolutely essential to retaining my clients' business. That to me is principally a business purpose.

J.H.: I'll have to admit that that type of expense might be deductible if the principal motivation is business; but I can't allow it here. If you want that deduction you'll have to go to the appellate staff or furnish me specific proof.

J.S.S.: Give me a week; I think I can furnish proof that will convince you.

J.H.: You're free to try. Now part of that expense you mentioned was for meals for your wife and yourself. That's not deductible.

J.S.S.: It certainly is. Those expenses were necessary to the entertainment of clients, and that entertainment was an ordinary and necessary expense of my business. I would never have afforded myself or my wife such luxuries unless I felt it was essential to my business.

J.H.: If you can show me that when you come back next week I'll allow part of that expense. However, under the *Sutter*[6] case I'll have to disallow the part of the expenses you would have incurred for yourself anyway. You have to prove that the expenditure for yourself was different from or in excess of what it would have been if you had eaten alone.

J.S.S.: I don't think any of it is nondeductible. Look here, I spent $40 for this meal. That's certainly different from and in excess of what I would otherwise have spent. Even under the rule as you state it, the whole thing is deductible. Anyway it's ridiculous to disallow 75¢ out of a $40 meal.

J.H.: I'll agree that is almost *de minimus* but unless you convince me that you and your wife would have skipped both the food and drink that night if you had not gone out I will have to disallow a part.

J.S.S.: How about this next one?

J.H.: You mean the meals for yourself on nights you worked late at the office?

J.S.S.: Yes.

J.H.: That's not deductible. That was settled squarely in the *Gunther*[7] case.

J.S.S.: I guess I'll have to accept that. At the time I made out my return I was under the impression that such expenses would be deductible.

J.H.: Now let's look at this amount that you have for club dues. Could you give me some detail on that?

J.S.S.: I have three of them here. The University Club, the Athletic Club and Junior Chamber of Commerce. The University Club is practically all business and I've deducted all the dues to it. I've deducted 60% of the dues to the Athletic Club because I do use it for some personal recreation.

J.H.: What about the members of your family? Don't they use these clubs? I'll bet they eat at the University Club with you, entertain there and things like that.

J.S.S.: No, we could, but we just don't use it for the family's social purposes. I maintain that membership strictly to entertain business associates. Now my family does use the Athletic Club. All ten of my children use the swimming pool and if my wife entertains friends downtown she uses that club rather than the University Club; however, even at that club, my use for business purposes predominates. I felt I was being generous when I limited my deduction to 60%.

J.H.: Show me that your wife and children haven't used the University Club and I'll accept your statement that your own use of it is strictly for business purposes. However, if 11 members of your family use the Athletic Club strictly for personal reasons, I don't think I can give you 60% of these dues. I might be willing to allow something like 20%. What about the Junior Chamber of Commerce? Why do you claim those dues as deductible expenses?

J.S.S.: That is an organization which, I feel, renders a valuable service to the community and I spend a lot of time on it. You shouldn't discriminate against that type of expense. I enjoy the company of the members but the more important fact is that it helps me to become known in the community.

J.H.: Those aren't business reasons. They're personal. I can't allow them.

J.S.S.: Well, all right; I'm not going to argue too strenuously. I don't agree with your allocation but at least you do recognize that club dues may be deductible.

J.H.: What are these expenses you have labeled "Trip to New York?"

J.S.S.: Oh, that is easy. That was the trip to the New York University Tax Institute; it was settled in the *Coughlin*[8] case that this is a deductible item for a lawyer. The Commissioner certainly fought to establish that education at this type of school is a personal expense and nondeductible. It seems to me that the cost of going to law school ought to be a deductible expense for any lawyer who subsequently practices.

J.H.: That may be, but it is not, nor is the cost of brushing up for a bar examination.[9] Educational expenses which

[1] Welsh, 290 U.S. 114 (1933).
[2] DuPont, 308 U.S. 488 (1939).
[3] Welsh, *op. cit. supra*, note 1.
[4] Eugene H. Lorenz, TCM Dkt. No. 17811, 8/25/49.
[5] Lyndol L. Young, TCM Dkt. No. 57876, 11/29/57.
[6] Richard A. Sutter, 21 TC 170 (1953).
[7] Charles O. Gunther, Jr., et al., TCM Dkt. No. 40174, 10/21/54.
[8] Coughlin, 203 F.2d 307 (1956); Bistline, 145 F.Supp. 802 (1956).
[9] Edward W. Banigan, TCM Dkt. No. 28619, 6/14/51.
[10] Coughlin, *op. cit. supra*, note 8.
[11] Cohan, 39 F.2d 540 (1930).
[12] Rev. Rul. 54-195, 1954-1 CB 47.
[13] Rev. Rul. 54-497, 1954-2 CB 76.
[14] Reg. §1.62-1 and 1.162-2.
[15] Reg. 1.162-2(c).
[16] Siegfried, 55-2 U.S.T.C. ¶ 9531 (Okla. N.D. 1955); Robert L. Grey, 10 TC 590 (1948); Julius Forstmann, 6 BTA 21 (1927); M. L. Cottingham, TCM Op. Dkt. No. 46721 (8/14/56); Dave S. Josephs, TCM Op. Dkt. No. 110501 (11/20/42). *See also* Rev. Rul. 54-429, 1954-2 CB 53; G.C.M. 18430 1937-1 CB 137.
[17] Horace Podems, 24 TC 21 (1955).

are made to establish someone in a trade or increase his earning capacity or his cultural background are nondeductible personal expenses. Generally, only the refresher course of short duration, which is not taken toward a degree, can be deducted.[10]

J.S.S.: What about this bar association convention I attended? You don't question that expense do you?

J.H.: No problem on that one; your expenses in connection with it are deductible; but I am going to question the expense of attending this construction workers' convention in Denver. How do you justify that?

J.S.S.: Well, I think perhaps I will defer my proof on that until next time I come in since you are requiring so much detail. Suffice it to say for now that I went there because of some construction clients I represent. There were talks given which I felt it was necessary for me to hear and I actually secured several clients as a result of the contacts I made while I was there. This was a necessary business expense for me and I got business from it; but I will bring in the details next time.

J.H.: I'm inclined to accept the fact you didn't attend that convention for personal reasons, but I will have to see more detail on your expenses. For example, if you took some sidetrips, we'll have to establish some proration. Under the *Cohan*[11] case we are required to allow some deductions which are not fully itemized but the records you have shown me so far are too vague even by those standards. You might want to look at *Rev. Rul.* 54-195[12] and *Rev. Rul.* 54-497.[13]

J.S.S.: Just out of curiosity, why was my return pulled for audit this year? I don't believe it has ever been looked at before.

J.H.: Frankly, your return was picked out because you didn't itemize any reimbursed expenses at line 6(a). We can't believe you didn't have any. For example, I'll bet you've done some traveling sometime and been reimbursed for your plane fare, motel, meals, and things like that.

J.S.S.: Sure, that's pretty commonplace for me. I travel for a client and he reimburses me. It washes out, so there's no use reporting it.

J.H.: But now you have to. You have to include the reimbursement of income and deduct what you spend.

J.S.S.: Oh, that's absurd. I'm not incurring any expense; my client is. Besides, I'm not an employee.

J.H.: Whoa! I don't care whether you're an employee or not. The return form doesn't say anything about being an employee.

J.S.S.: Look again. At line 6(a) you report reimbursed expenses, don't you?

J.H.: Yes.

J.S.S.: What section of the Code covers them?

J.H.: Well, let's see. Here it is. Section 62(2)(A).

J.S.S.: All right. Look at it closely. Section 62(2) is labeled "Trade and Business Deductions of Employees," and even the Regulations make it clear that this reporting requirement applies only to employees.[14]

J.H.: Well, by gosh you're right. But you're an employee of your clients.

J.S.S.: No. I'm an independent contractor. Now take Lem Flem in my office. Works for me. He's an employee, and you might claim he'd have those problems.

J.H.: Let's get his return and take a look.

J.S.S.: Don't bother. You won't find anything on his return on line 6(a). We've gotten around that requirement.

J.H.: What? How's that?

J.S.S.: Well, first of all, when Lem does some traveling for me or for a client, his employment agreement gives him the right, as my agent, to spend my money for his expenses. So, when he advances his money for those traveling expenses, I become obligated to repay him.

J.H.: Right. The Regulations provide that those are reimbursed expenses which have to be deducted at line 6(a).

J.S.S.: Sure, but if he deducts them at line 6(a) he'll understate his income.

J.H.: No, no, no. He also has to include in his income the repayment of the expense. Therefore, they wash out and his income is not understated.

J.S.S.: But you've missed the point. The reimbursement is not income to him. It's merely my repayment to him of a debt which I owe him. Have you ever heard of a repayment of a debt being taxable income?

J.H.: No. I agree that the repayment of a debt isn't taxable income, but this is the reimbursement of an expense. Let me read you the Regulations. They say: "If an individual receives a salary and is also paid his actual traveling expenses, he shall include in gross income the amount so repaid and may deduct such expenses."[15] Now, I don't care whether you consider this the repayment of a debt or not. It falls within the express language of that regulation, and must, therefore, be included in income.

J.S.S.: Where were you reading from? I've never seen any regulation like that under the definition of gross income.

J.H.: No, you wouldn't have, because this regulation is under Section 162, which relates, among other things, to the deduction of traveling expenses.

J.S.S.: That seems an odd place to put a regulation defining gross income — the statute defines it in Section 61. Here, let me see it. *(Rereading)*

J.H.: Satisfied?

J.S.S.: I think you've missed the heart of it. This regulation is obviously speaking of a person's own deductible expenses being repaid to him. As I said, I only reimburse Lem for expenses of my own which he incurs for me. A number of cases have held that a reimbursement of an *employer's* expense incurred by the employee on behalf of his employer *doesn't* constitute income to the employee.[16]

J.H.: I think that's quibbling. It certainly isn't in compliance with the spirit of the Commissioner's instructions regarding line 6(a).

J.S.S.: Maybe so. Maybe so. But, if that's true, we can easily get around it in another way next year.

J.H.: You've got me interested. You know I have to report this stuff myself. What's your gimmick?

J.S.S.: Well, suppose I merely advance $150 to Lem before he makes a trip for me. The money won't be his under any claim of right, and I'll give him express instructions as to what use he can make of it. Any amount he doesn't spend he has to return to me.

J.S.: That's no different from what you're doing now. You still reimburse him for money which he spends for you.

J.S.S.: No, he's actually using my money. He's not spending any of his own. What's the difference between that and the situation of a treasurer of a corporation who disburses company funds by check? Surely you wouldn't claim that everything spent by that treasurer for his employer is taxable income, would you?

J.H.: Certainly not. I think it comes down to a much more practical, and less theoretical, level. I'll grant you can't always logically reconcile all of the tax law with the Commissioner's instructions on line 6(a), because the decision to include that line on the return was primarily made to help in the enforce-

ment of the law. What we're trying to reach is the use of employer's funds for *personal* expenses of an employee. For example, some employee takes a vacation trip to Florida for two weeks and the company reimburses him for all of his expenses. You'll grant that that's income to the employee, won't you?

J.S.S.: Yes, I'll have to admit that.

J.H.: Well, you know as well as I do the Commissioner has never had any success in getting taxpayers to report that type of income, so now he's adopting the shotgun approach. He's telling us that we have to report all of this type of reimbursement, regardless of whether it's a reimbursement of a legitimate expense of the employer, and then deduct just those expenses. That way we can tell at a glance where the big fish are, and our audits of expense allowances will be more productive. Actually, this isn't much different from what the Commissioner could do in each individual case if he wanted to. Even now, when he finds a taxpayer who has been avoiding the law by not reporting reimbursements of his personal expenses, the Commissioner uses that same shotgun approach in his 90-day letter. He determines that all of the reimbursement of the expenses incurred by the employee are taxable income to him regardless of whether they were spent for ordinary and necessary business expenses of the employer, then he puts the burden on him to prove the legitimate expenses. The Tax Court has always accepted that type of a determination as being reasonable, and now the Commissioner is merely asking the taxpayer to do that right on his return. If you could evade the new reporting requirements as easily as you suggest, we'd be right back where we started.

J.S.S.: Nevertheless, that's your problem, not ours. We don't have to do the things the law doesn't require us to do, and if the reimbursement doesn't constitute taxable income, then we don't have to report it as such; and if we don't report the reimbursement as income, not even the Commissioner would want us to deduct the expense.

J.H.: I think you've overlooked something. The law gives the Commissioner pretty broad discretion in determining what information you have to give on your return. It's not as simple as your statement that you only have to report your actual gross income. Section 6011 of the Code says, and I quote, "Every person required to make a return or statement shall include therein the information required by such forms or regulations." And it also states that the return shall be made according to the forms prescribed by the Secretary of the Treasury or his delegate. Therefore, I don't think you're free to make the decision that the reimbursement doesn't constitute gross income, and therefore need not be reported.

J.S.S.: I'll have to concede that point, of course, but I don't believe that the present return, or the Regulations of the Commissioner, require that information be given with regard to reimbursement of expenses which don't constitute gross income. After all, line 6(a) on the return is designed to set out an amount of *expense* which can be deducted from gross income. Therefore, the really crucial question is, whether any of the lines on which *income* is reported require the inclusion of the reimbursement of the expense even though that reimbursement isn't income. I don't think that any of the lines do. For example, line 5, where the Commissioner apparently feels the reimbursement of expense should be included, states only that the taxpayer shall: "Enter all wages, salaries, bonuses, commissions, tips and other compensation received in 1958 before payroll deductions." It doesn't say anything about reporting nontaxable income.

J.H.: Well, I'm not going to argue that point with you. You may or may not be right. But I feel pretty sure of this. If a lot of people evade the new reporting requirements with the gimmick that you propose, it won't be long before the Commissioner changes the return form again in order to make sure that all of the reimbursement of expenses is reported, regardless of whether it comes about through an advance by the employer prior to the expense or the reimbursement of the expense after it has been incurred.

J.S.S.: Fair warning, I guess, but don't be too sure the Commissioner will get what he wants when he changes the return that way. We've got still another plan which ought to keep us ahead.

J.H.: What's that? Fire all of the employees and hire them back as independent contractors?

J.S.S.: Not at all. Nothing as impractical as that. I'll simply furnish Lem with credit cards by which he'll be able to charge all of his expenses incurred on my behalf except miscellaneous ones like tips that will be so nominal they won't be worth messing with. Then he'll never disburse any money but merely charge things and I'll pay them directly. How do you expect to reach that?

J.H.: Well, I'd be inclined to agree that the reporting requirements will not cover that type of expense payment. After all, the expense is an ordinary and necessary business expense of the employer if the employer actually pays the money. I think it would be awfully hard to make the employee report that expenditure on his own return. But even there, it's arguable that the employee constructively receives money when he charges his traveling and other expenses on a credit card furnished him by his employer. However, coming back to the Commissioner's practical approach once again, your last suggestion doesn't have the evasion possibilities which are so inherent in the other expense reimbursement methods; the Commissioner may not object too much if that type of payment is not reported by the employee.

J.J.S.: I'm not so sure that arrangement doesn't have evasion possibilities. For example, take the case of a corporation that pays club dues for its officers, strictly as a fringe benefit for the officers, and without any thought of advancing the business of the employer.

J.H.: Well, I agree there are some evasion possibilities but they're present now, and it's also clear that the law requires that type of payment to be reported by both the employee on his tax return and the employer on an information return. We'd better leave that question for next year and move along now or we won't have time to cover some of these other items. I particularly wanted to ask you about these automobile expenses. You've got them set out in considerable detail and your records on them look good, so I'm going to accept the fact that you actually spent these amounts. These expenses were apparently incurred when you used your automobile on behalf of your clients, weren't they?

J.S.S.: Yes, that's right. I'd do some driving around for clients, and therefore I don't think there is any question

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about the expenses being deductible.

J.H.: But, now, isn't this true? Don't your clients reimburse you for the expense of your automobile when you use it for them?

J.S.S.: Oh, yes, they normally do on longer trips, but on short trips I never bother to collect, and sometimes on a longer one I forget.

J.H.: That's what I thought. So, then, if you wanted to take the trouble, you'd be entitled to get reimbursed for those expenses, wouldn't you?

J.S.S.: Yes, I think you could say that.

J.H.: Well, then, it's clear that those expenses are not deductible.

J.S.S.: What do you mean — not deductible? They're ordinary and necessary business expenses.

J.H.: Oh, they might be that all right, but if you have the right to be reimbursed for those expenses, they're not deductible.

J.S.S.: Well, that's an odd statement. Where did you ever get that idea?

J.H.: Well, a friend of mine in the Service had a very sad experience with the Tax Court and that's why I remember so well the authority for denying this deduction. If you will just look under his name, *Horace Podems*,[17] you will find the decision right in point. He did the same thing you did. He used his automobile to get around in making audits of taxpayers' returns and he could have been reimbursed by the Government on a mileage basis; but half the time he just neglected to put in his expense vouchers. The Tax Court didn't doubt his proof of the expenses, but said — well, here, let me read to you from the decision: "He filed vouchers for many of the months and there was no excuse for him failing to file vouchers for all of the months. Expenses to be deductible must be both ordinary and necessary. Obviously, it was not necessary for Horace to remain unreimbursed for the expenses of his automobile to the extent that he could have been reimbursed had he taken the trouble to file a voucher and be reimbursed by his employer. Those amounts were not ordinary and necessary expenses of Horace's business."

J.S.S.: Oh, come now, I think he was bilked. Who represented him in that case?

J.H.: Oh, he represented himself.

J.S.S.: Well, no wonder. Horace isn't a lawyer, is he?

J.H.: I don't know.

J.S.S.: Well, you tell Horace that even we lawyers feel that we shouldn't represent ourselves in a courtroom. Whether or not a legitimate expense can be reimbursed should make no difference as to whether it is deductible. If it's not reimbursed, it's been spent, regardless of whether it *could* have been reimbursed. But say, that case is in a way consistent with my theory of reimbursed expenses. The Tax Court's theory must have been that when Horace spent his own money on the Government's business, there arose at the same time a debt from the Government to him, and therefore, he hadn't actually spent any of his own money. On that theory, maybe the court could legitimately disallow the expense.

J.H.: Well, I hadn't looked at it that way before.

J.S.S.: But you see, even if the court could reasonably disallow the expense on that basis, they would have to admit that once the debt became uncollectible, Horace would be entitled to a bad debt loss. So why don't you tell Horace to submit his vouchers for those expenses now, and when the Government refuses to pay him because it's too late, claim a bad debt loss.

J.H.: That sounds like a good idea! He might go for that.

J.S.S.: So then you agree that my automobile expenses are deductible?

J.H.: I guess I'll have to now.

J.S.S.: Next time, tell Horace he had better get himself a lawyer.

J.H.: That's too darned expensive. He can't afford it.

J.S.S.: Well, just bear in mind that the fee which he pays to his lawyer is deductible from his taxable income, so that, in fact, the Government is paying part of his lawyer's fee.

J.H.: Yes, I guess there's not much question about that under the 1954 Code.

And on that encouraging note, we slip as quietly as possible out of the conference room, leaving J. Stainless Steel and Jack Hitax still hard at work on the former's return. ☆

Support for dependent now includes rent value of home

WHEN YOU ARE figuring out whether your mother-in-law, who lives with you and has a little income of her own, is a dependent or not, how much can you include in the support you give her for the fact that she lives in your home? The IRS has outstanding a rule (*Rev. Rul.* 235, 1953-2 CB 23) saying that you can't include the rental value of quarters furnished; that the limit you can claim is a fair allocation of total out-of-pocket expenses: taxes, interest, repairs, etc. Although this ruling is unrevoked, the Service takes a different position in the 1958 edition of "Your Income Tax." That pamphlet says flatly that you can include the rental value of her quarters as support you furnish her.

The Tax Court has twice held that the rental value computation was proper (*Blarek*, 23 TC 1037 and *Haynes*, 23 TC 1046). The IRS announced nonacquiescence in both of these cases but withdrew its appeals to the circuit court. In the *Blarek* case, the Tax Court said that support in the Code was used in its ordinary sense and that rental value was the best measure of the value of the lodgings received as part of the support.

The Commissioner's position, until he made this changeabout in "Your Income Tax," has been that support should be measured by actual expense, not value.

Rev. Rul. 1953-235 explained it thus: "The term 'support' generally includes such items of expense as the cost of board, lodging, clothing, education, medical and dental care, and other similar expenses. However, in determining the amount of support furnished in the form of lodging to such a closely related person, reference must be made to the actual expense of furnishing the lodging involved and not to the value of the lodging furnished. Accordingly, it is held that the fair rental value of a house owned by a taxpayer in which lodging is furnished to a dependent parent (whether or not the parent lives with the taxpayer) may not be taken into account in determining whether over half of that parent's support was furnished by taxpayer. The types of expenses which may be included in determining the cost of furnishing lodging to a dependent are such items as property taxes, mortgage interest, property insurance, and ordinary repairs. Depreciation and expenditures properly chargeable to capital account, including payments on the principal amount of a mortgage, may not be included for the purpose of such determination.

"By the same token, if the taxpayer and his dependent parent live in a house owned and furnished by the parent, the fair rental value of the house is not to be taken into account in determining

whether the taxpayer has furnished more than half of the parent's support for purposes of the dependency credit.

"These cases are to be distinguished from those where the taxpayer or the dependent, as the case may be, furnishes lodging in a *rented* home. In such a situation, since it is an item of actual expense, the rent paid for the living accommodations should be included in determining whether more than half of the dependent's support was furnished by the taxpayer."

Incidentally, it strikes us as very poor practice to make a change which affects so many taxpayers in such an inconspicuous way. ☆

Final Regulations allow fee for tax advice

THE REGULATIONS under Section 212 as originally proposed took a rather narrow view of the provision, new in the 1954 Code, that deduction is allowed for expenses "in connection with the determination, collection, or refund of any tax." The proposed Regulations were criticized by tax men because they made no mention of fees incurred for tax advice not related directly to the preparation of a return or a contest. The final Regulations specifically include the right to a deduction for such a fee.

The proposed Regulations said (Reg. 1.212-1(l): "Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, state or municipal, and whether the tax be income, estate, gift, property or any other tax are deductible. Thus expenses incurred in connection with the preparation of tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting a tax liability are deductible."

But, when the final Regulations came out, the phrase "for tax counsel" was added, making it clear that a particular return or controversy was not a prerequisite for deduction.

The final Regulations read: "Expenses paid or incurred by an individual in connection with the determination, collection or refund of any tax, whether the taxing authority be Federal, state, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting a tax liability are deductible." ☆

New form issued for taxpayers claiming child care deduction

THE TREASURY has a new form, Number 2441, to be attached to the Form 1040 of taxpayers claiming deductions for the care of children and certain other dependents. The instructions, as you will note below, discuss only two of the myriad situations in which the cost of child care is mingled with other expenses: the total fee paid to a nursery school could be deducted even though lunch is provided for the child, but only the portion paid for child care will be allowed if a housekeeper is paid to do housework as well as provide care.

Instructions

"A deduction is allowed for expenses paid during the year by a woman or widower for the care of one or more dependents if such care is for the purpose of enabling such taxpayer to be gainfully employed. The term 'widower' means a man who has not remarried since his wife died or since he was divorced. It also includes a man who is legally separated from his wife. The deduction is not allowed for amounts which you pay to a dependent for the care of another dependent.

"The only dependents for whom the 'child care' deduction is allowed are those who are either (1) under 12 years of age, or (2) physically or mentally incapable of caring for themselves.

"In general for this expense to be deductible it must meet three conditions: (1) The expense must be for the care of a dependent, (2) it must be for a dependent's care while the taxpayer is gainfully employed or in search of gainful employment, and (3) the expense must be for the purpose of enabling the taxpayer to be gainfully employed.

"Expenses for the care of a dependent are amounts expended for the primary purpose of assuring the dependent's well-being and protection. They do not include all benefits which may be bestowed upon him. Accordingly, amounts expended to provide food, clothing, or education are not in themselves amounts expended for 'care' so as to be deductible. However, where the manner of providing care is such that the expense which must be incurred includes pay-

FORM 2441 (Oct. 1957)

U. S. Treasury Department—Internal Revenue Service

STATEMENT OF EXPENSES FOR CARE OF CHILDREN AND CERTAIN OTHER DEPENDENTS

For Taxable Year .....

Attach this statement to your Income Tax Return, Form 1040

The deduction for "child care" is not allowable if you take the standard deduction on Form 1040 or if you file Form 1040A

1. Name of taxpayer claiming the deduction .....
2. Marital status of taxpayer (see instruction F and check appropriate box):
   ☐ Single; ☐ Married; ☐ Widow; ☐ Widower; ☐ Divorced; ☐ Legally separated.
3. Name of child or other dependent for whom expenses were paid | If under 12 years of age, please check | If 12 years of age or over, explain reason for expenses (see instruction B)
   ..... ☐ .....
   ..... ☐ .....
   ..... ☐ .....
   ..... ☐ .....
4. Person(s) or organization(s) to whom payments were made and amount paid to each:
   ..... $..... ..... $.....
   ....
   ....

COMPUTATION OF DEDUCTION

5. Total amount of expenses paid ..... $.....
6. Amount, if any, paid for services other than direct care of dependent(s) listed in line 3 (see instruction D) ....
7. Balance (line 5 less line 6) ..... $.....
8. Enter the amount on line 7 or $600, whichever is lesser. This is the allowable deduction for persons other than working wives. $.....
9. Limitation for working wives (see instruction G):
   (a) Enter amount shown on line 11, page 1, of your joint return, Form 1040 ..... $.....
   (b) Less 4,500.00
   (c) Balance ....
10. Allowable deduction for working wives (line 8 less line 9) ..... $.....
    (Enter the amount on line 8 or line 10, whichever is applicable, under "Other Deductions" on page 2 of Form 1040)

ments for other benefits which are inseparably a part of the care, the full amount will be considered to be incurred for care. Thus, the full amount paid to a nursery school will be considered to be for the care of the child, even though the school also furnished lunch, recreational facilities and other benefits. In those cases in which you pay a person to do both housework and take care of a dependent, only that part of the expense which is for the dependent's care qualifies for the deduction.

"The deduction is allowed only with respect to such expenses actually paid during the taxable year regardless of when incurred.

"Question 2 concerning the marital status of the taxpayer should be answered as of time expenses were incurred. "If the expenses are paid by a woman who is married at the time the expenses are incurred and whose husband is capable of self-support, the deduction is allowed only if she files a joint return with her husband for the year in which the expenses are paid. Further, the amount of the expenses must be reduced by the amount, if any, by which the combined adjusted gross income of the taxpayer and her husband exceeds $4,500. This limitation to reduce the expense does not apply if the husband is physically or mentally incapable of caring for himself. However, in such case enter on the reverse side of this form: (1) nature of husband's disability, (2) the period of disability, and (3) the amount, if any, of the husband's earnings during the period." ☆

New decisions affecting individuals

Can deduct tool transportation cost but not commuting. In two separate cases, a general mechanic and a foreman, both of whom worked at a lumber mill and were required to do certain on-the-job traveling by their own means of transportation, and at their own expense, are allowed that portion of their truck expenses applicable to the transportation of their tools and equipment between the home and the mill, and on-the-job trips, but not the portion applicable to their own transportation. The court applies the *Cohan* rule to determine the amount of expenses incurred. *Eaton*, TCM 1958-13; *Ciro*, TCM 1958-16. A "yarder operator" at the same mill whose employment did not require him to transport equipment or do any on-the-job travel is denied a deduction for expenses connected with his vehicle. *Sciume*, TCM 1958-15.

Legal expenses to regain control of corporation deductible. Taxpayer's father fired the first shot in a family war when, objecting to taxpayer's proposed marriage, he summarily removed him as president of the family corporation. In the ensuing struggle, in which taxpayer's mother joined his father, some thirty lawsuits were brought. Ultimately taxpayer regained control of the corporation and was restored to the presidency with compensation for the unlawful dismissal. The court holds the attorney's fees paid in carrying on this legal campaign were deductible as expenses incurred in the production of income and the conservation of income-producing property. But a fee paid for an opinion as to the corporation's potential Section 102 liability was not deductible; that was an expense of the corporation. *Ingalls*, DC Ala., 1/29/58.

Portion of legal expense allowed as deduction for services actually rendered. Taxpayer paid $52,500 for legal and accounting services, but the court allocates only $6,250 to services actually rendered to taxpayer. The balance was paid in connection with another corporation's acquisition of taxpayer's stock and the contemplated acquisition of other concerns. *G. Haiss Mfg. Co.*, TCM 1957-241.

O'Dwyer's expenses as ambassador estimated [*Acquiescence*]. William O'Dwyer's accountant totalled his expenses in 1950 and 1951, while he was ambassador to Mexico, at $7,000 and $28,000. The Government reimbursed $500 and $10,000. The allocation of the remainder between business and personal was, the court states, not explained. The court allows the former New York Mayor $1,900 in 1950 ($6,000 claimed) and $8,000 ($12,000 claimed) in 1951 as unreimbursed business expense. *O'Dwyer*, 28 TC 689, *acq.* IRB 1958-3.

Wet entertainment in dry state deductible; use not illegal. Oklahoma statutes make it unlawful to sell liquor in the state. But the court finds there is no public policy against the personal use and possession of liquor within the state. Taxpayer, an attorney, furnished liquor in connection with entertaining clients and prospective clients. The entertainment expense is allowed. *Winters*, DC Okla., 1/2/58.

Rhode Island cigarette tax is deductible as a retail sales tax. The Rhode Island tax on cigarettes evidenced by stamps affixed to the package is held to be a retail sales tax and as such would be deductible by those consumers who elect to itemize their deductions. *Rev. Rul.* 57-442.

Cincinnati earned income tax not deductible for adjusted gross income. The earned income tax imposed by the City of Cincinnati constitutes an income tax and as such is not deductible by an individual in computing his adjusted gross income. The tax, when imposed on an individual proprietorship, is deductible by the individual in computing taxable income if he does not elect the standard deduction. However, the tax on a partnership is deductible in determining the taxable income of the partnership and the individual partners may claim the standard deduction. *Rev. Rul.* 58-25.

Swimming pool held medical expense. The jury in this case held that the cost of constructing a specially designed swimming pool for hydrotherapy of a polio victim is a deductible medical expense, rather than a capital improvement to his home. *Mason, DC* T. H., 9/30/57.

"Autoette" qualifies as medical expense. The cost of an autoette, a three-wheeled motor vehicle designed for the disabled, is an allowable medical expense when used by such a person, provided it is not used primarily for transportation to and from work. Item 13 of *Rev. Rul.* 55-261, modified. *Rev. Rul.* 58-8.

Partial allowance of T&E, salaries to sons [*Acquiescence*]. Commenting on meager records of services performed by the college-student sons of taxpayer's stockholders, the Tax Court allows about one-third of the $600 to $2,500 salaries it claimed. Similarly, it cuts the travel and entertainment expense and allows one-third of the $6,000 to $10,000 a year claimed. *Finley*, 27 TC 413, *acq.* IRB 1957-49.

PROBLEMS ARISING FROM

Special tax treatment

OF PARTICULAR INDUSTRIES

Capital gains provisions for real estate investors in Sec. 1237 more promise than fact

by **LEO SPANDORF** *and* **EMANUEL D. TONELSON**

Investors in unimproved real estate who, as a practical matter, can realize on it only if they subdivide, face an extremely difficult tax problem. The flood of litigation on the issue creates more confusion than clarity, and Section 1237, which was supposed to provide workable rules is, tax men are coming to realize, almost impossible to use. Messrs. Spandorf and Tonelson analyze the statute and the confining regulations, some of which, they believe, have little basis in the Code. They conclude that 1237 provides little real help—if the taxpayer can prove he is an investor, he doesn't need it; if not, he can't qualify for its benefits.

As a relief provision included in the 1954 Code, Section 1237 is noble in purpose, nebulous in language and practically nullified by regulation. Congress was trying to remove from the area of litigation the taxation of persons who hold unimproved land for investment and to dispose of it must subdivide it and engage in active selling efforts.[1] To prevent real estate dealers and others holding unimproved land for sale to customers from benefitting, Congress in enacting Section 1237 and granting capital gain treatment, set up certain basic qualifying rules.

1. Taxpayer is the one who subdivided.[2]

2. Taxpayer did not previously hold the property for sale to customers.

3. Taxpayer held the property for at least five years except where acquired by inheritance or foreclosure.

4. No substantial improvements were made on the property. Where necessary improvements were made, a ten-year holding period together with other conditions is required.

If the above conditions are met, the first five sales from a tract are given capital gain treatment. In the year of the sixth sale, 5% of the selling price less expenses of all sales made that year and in succeeding years are taxed as ordinary income, the balance of the profit as capital gain. Thus, where possible, the first five sales should be in one year, and the sixth and subsequent sales in the succeeding year. If the first six sales are made in one year, then all such sales are subject to the 5% rule. The Regulations state that where the 5% rule is applicable, the gain shall be ordinary income to the extent of 5% of the selling price less selling expenses. The balance of the gain is subject to capital gain rates. The entire gain is capital where selling expenses equal or exceed 5% of selling price. A sale of two or more contiguous lots to a single buyer is deemed to be one sale.

Section 1237 refers only to gains and not losses. To obtain an ordinary loss, the taxpayer must take the position that the property was held for resale or that he is a dealer.

Although the Regulations state that Section 1237 shall apply to sales made after December 31, 1953, sales made prior to December 31, 1953 shall be considered in determining the "sixth sale" as described in Regulations. Section 1237-1 (e).

Where Section 1231 property (held in a trade or business) is subdivided by the taxpayer who engages in sales activities connected with such property, then Section 1231 governs and any gains are deemed to be capital gains. Section 1237 will not be applicable even though all the conditions are met.

Corporations, originally excluded from Section 1237 benefits, are included by Public Law 495, approved 4/27/56, if:

1. No stockholder either directly or indirectly holds real property for sale to customers, and

2. The property was acquired through the foreclosure of a lien which secured a debt owed to the corporation or the foreclosure bid was transferred to the corporation by the creditor in exchange for all the corporate stock and other consideration.

The holding period

The holding period can be tacked on from one taxpayer to another under the general provisions of Section 1223(1). Thus, the making of a gift of property from a father to a son does not start the five-year holding period anew. If real property is acquired by a taxpayer in a liquidation of a corporation under Section 333 (liquidation within one month, unrealized gain not taxed), the holding period of the real property is deemed to begin at the date of acquisition of the real estate by the liquidating corporation. This special real estate rule is contrary to the general provision of Section 334(c) that the property received in an exchange under Section 333 shall be deemed to have been held from the date of acquisition of the stock surrendered in the exchange.

The five-year rule is waived for property acquired by inheritance or devise but not for property acquired by survivorship in a joint tenancy or under the community property laws. The inconsistency in tax treatment under the Regulations of a widow acquiring property by survivorship as compared with a widow acquiring property by inheritance appears to be without justification. The holding of real property by a joint tenancy is a common practice and should not be be placed in an unfavorable tax position. There is some mitigation of the disadvantage, however, in that the Regulations state that the holding period begins with the date of original acquisition.

Holding for sale disqualifies

The Code limits the disqualification to use Section 1237 to the holding of the

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tract primarily for sale to customers in a prior year or in the year of sale; or the holding of any other real property for sale to customers in the same year in which the sale occurs.

The Regulations state that subdividing[3] and selling activities shall be disregarded in determining the purpose for which real property has been held whenever such activities are the only substantial evidence indicating that the taxpayer has ever held property for resale.

On the other hand, if there is other substantial evidence of activities other than the subdivision and selling of a particular tract of real property, such other activities may prevent the taxpayer from availing himself of the benefit of Section 1237. The examples cited are: selling activities with other property in prior years concurrent with the selling activities of the subdivided tract; intention to hold the tract for sale in prior year; subdivision of other tracts in the same year; holding of other real estate for sale in the same year; and the construction of a permanent real estate office which the taxpayer could use to sell other property.

The Commissioner, by regulation, now deems that the disqualifying-substantial-activities test includes selling activities with other property in a prior year at a time when the taxpayer attempted to sell the subdivided tract, whether or not such tract was held previously for sale to customers. The taxpayer may be denied the capital gains benefits of Section 1237 if after holding two separate tracts as investments for over five years, he decides to subdivide both parcels for immediate liquidation. Only one at a time, rules the Commissioner. Furthermore, the construction of a permanent office may be a prohibited activity. Either the taxpayer conducts his selling activities in a shanty ready to collapse in the next gale or he faces the prospect of having the gains taxed at ordinary rate. On the other hand, the Regulations are mute as to the consequences to the taxpayer if he rents a palatial permanent real estate office from another or from a related person or from a controlled corporation.

Selling activities disqualify

Should the taxpayer somehow get by the above tests, he faces another series of disqualifying situations with respect to selling activities. If more than one of the following exist, the circumstances may or may not contribute substantial evidence that the taxpayer has held real property for sale in his business, depending upon the particular facts in each case:

1. Holding a real estate dealer's license
2. Selling other real property held clearly for investment
3. Acting as a salesman for a real estate dealer
4. Mere owning other vacant real property without engaging in any selling activity whatsoever with respect to it.

Thus, the mere holding of real property plus the sale of real property held solely for investment may be sufficient to deny Section 1237 benefits on the sale of subdivided realty. Where more than one of the above situations exist, the taxpayer can find little comfort or assurance in the words "may or may not . . . depending upon the particular facts in each case."

The attribution rules with respect to the holding of property should offer no problem to the taxpayer unless he is a member of a partnership or owns real property jointly with others. The familiar family attributions do not apply in the holding of real property. Taxpayers who are participants in realty syndicates may find themselves unable to obtain 1237 benefits under the partnership attribution.

Other tests

Another concept created by the Regulations is the "prior-owner-purpose test." As an example in the Regulations puts it, if a real estate dealer gave a tract of real estate to his son as a gift, the son ordinarily could not avail himself of Section 1237 benefits although the five-year-holding-period test was met. This concept is a creation of the Commissioner and finds no support in the statute or Committee Reports. Though the son has no connection with his father's real estate business, he becomes tainted for purposes of Section 1237. Of course, if the transfer of land by gift is a sham or fraud perpetrated to avoid the tax, the Commissioner certainly has equity in his position. However, if the gift was a bona fide transfer, the imputation of the dealer status to the son appears to be an unwarranted extension of the attribution rules.

Disqualifying improvements

The "improvement test" is next on the list to determine the applicability of Section 1237. The improvements to the real property must not be substantial. Certain improvements will not be considered substantial if they are necessary to make the tract marketable under certain conditions. Thus, taxpayers are confronted with two additional terms, substantial improvements and necessary improvements.

There is a brief mention in the Regulations of improvements which will be considered substantial and which will not. Listed among the substantial improvements are permanent buildings, hard-surface roads and utilities. Among the nonsubstantial improvements are temporary field office, surveys, land clearing, drainage, grading and gravel-type all-weather access roads.

Improvements made by others will be attributed to the taxpayer if they are made by members of his family, a corporation in which he owns directly or constructively 50% of the stock, a partnership, a lessee (if improvements are in lieu of rent), any governmental agency levying a special assessment for the improvements, or by a purchaser under contract of sale. It does not seem equitable that a taxpayer should be precluded from using Section 1237 because of circumstances beyond his control. If a municipality builds sewers and assesses adjoining property owners, the taxpayer may under the Regulations find himself unable to use Section 1237.

Before any substantial improvement, cited above, will prevent the use of Section 1237, the improvement must increase the value of the lot sold by over 10%, an arbitrary percentage chosen by the Commissioner. Because there are many factors which create price fluctuations in real estate it would be neces-

[1] Senate Committee Report-83rd Cong., 2nd Session; S. Rep. No. 1622 page 115 General Report on Par. 1237.

[2] Int. Rev. Code, Sec. 1237(a) states ". . . shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided such tract. . . ." Also see House & Senate Committee reports which refer to an individual who subdivides.

[3] Since the Regulations fail to define, or describe a subdivision, local law should govern as to what constitutes a subdivision.

[4] See Footnote 2, *supra*, for reference to Committee Reports and Code. As to the Regulations,

sary and prudent for the taxpayer who has made substantial improvements to obtain an independent appraisal of the value of lots before and after the improvements. Each lot is to be considered separately. It is possible to have some of the lots in a tract increase by more than 10% and the remaining lots by less than 10%. Accordingly, the latter lots will still qualify under Section 1237 while the former may be ineligible. The great difficulties of the taxpayer in determining whether the 10% increase in value of lots arose solely from improvements will probably cause considerable litigation if the application of Section 1237 rests on the 10% rule.

The Regulations leave open one very narrow approach to Section 1237 benefits where improvements have been made: relief is available if the improvements are treated as necessary and not substantial. The conditions required are: a ten-year holding period; the improvements limited to drainage, utilities, hard-surface roads, curbs and gutters; the agreement of the district director that without such improvement, the lot would not have brought the prevailing prices for similar building sites; and an election not to increase the basis by the costs of the improvements. With these conditions, it will be remarkable if more than a handful of taxpayers qualify under this particular subsection. However, the fault seems to lie with the Code and not with the Regulations. The term "similar building site" and the manner of making the irrevocable election are set forth in detail in the Regulations. The administrative requirement that the taxpayer furnish the district director the selling price of comparable real estate in the vicinity of the taxpayer's property may be impossible to fulfill. If the property was acquired by foreclosure, the Regulations waive the "similar building site" requirement and the election to waive cost of improvements as an addition to basis.

What is a tract?

All continguous property held by a taxpayer is deemed to be a single tract. The taxpayer may hold such contiguous properties separately, jointly, or as a partner. The interposition of a road, stream or railroad does not disturb the contiguity. If no sales are made from a single tract for a period of over five years from the date of the last sale, then the tract shall be considered a "new tract" for purposes of computing capital gain on the sales of the first five lots under Regulations Section 1237-1(e).

It would appear that a gift of one parcel from a tract would in effect create two tracts for purposes of determining capital gain under Regulations Section 1237-1(e). Since the gift creates two separate owners of adjoining real estate, each under the terms of Regulations Section 1237-1(g)(1) owns a separate tract. The holding period of both tracts is the original acquisition date under Regulations Section 1237-1 (d) (1). The area for capital gains can be expanded by a family, a member of which holds unimproved real property qualifying under Section 1237. The subdividing of the property should commence after the transfer of the property by bona fide gifts. The Committee Reports, Code and the Regulations refer to taxpayers who subdivide the tract and then attempt to sell the lots.[4] Whether taxpayers who acquire subdivided property by purchase, gift, or inheritance can qualify under Section 1237 is not made clear or referred to in the Regulations.

The Regulations state that Section 1237 is not exclusive. Even though all the conditions of Section 1237 are met, the rule that 5% of sales after the sixth is ordinary income is not necessarily applicable; the entire gain can be capital gain if the taxpayer is in a position to prove that the real property sold was not held primarily for sale to customers in the ordinary course of his trade or business.

On the other hand, if any requirement of Section 1237 is not met, the failure shall not be determinative as to whether or not real property is held primarily for sale. The district director may conclude from convincing evidence that the taxpayer held real property for investment. Since the chances of convincing district directors of capital gain treatment are not considered favorable in these times, the taxpayer better be prepared to convince the courts.

On that note, we may conclude that this takes us back to the beginning—the period before Congress and the Commissioner decided that tax treatment of gains from subdivided real estate needed "clarification." If the taxpayer can prove that he is an investor, he does not want or need Section 1237. On the other hand, if his real property was held primarily for sale to customers, he cannot qualify under Section 1237.[5] ☆

see the second sentence of Reg. Sec. 1237-1(a)(1).

[5] The Regulations relating to Sec. 1237 appear to contradict themselves. The Committee Reports, Code and Regulations state that Sec. 1237 will permit taxpayers to sell real estate held for investment. The supposition is, of course, that the real estate taxed under 1237 was held for investment. Reg. Sec. 1237-1(a)(4)(i) state "even though the conditions of Section 1237 are met, the rules of Section 1237 are not applicable if without regard to Section 1237 the real property sold would not have been considered real property held primarily for sale to customers in the ordinary course of his business."

NEW DECISIONS ON DEPLETION—SPECIAL INDUSTRIES

Commissioner erred in requiring inventory of breeding animals. Taxpayer, a breeder of high-quality cattle and sheep, had since 1938 used the accrual method and computed inventory on the unit-livestock-price method. It had included breeding animals in that inventory (paying ordinary income tax on their annual increase in value in accordance with a schedule). Although the Code was amended to include breeding animals as capital assets, the Commissioner insisted that taxpayer required permission to remove breeding animals from inventory, and this permission he refused to grant until 1953. This case involves the years 1946-49. The district court held that taxpayer was correct in removing breeding animals from inventory. Capital assets are not inventory, and no permission is required. This court affirms. *Lewis,* CA-5, 1/20/58.

No revision of depletion allowance; error was ascertainable. Taxpayer asks for a revision of its depletion allowance for 1948 and 1949 on the basis of corrected estimates of recoverable units discovered by an actual cruise in 1952. The Tax Court pointed out that the error in the prior estimate was readily ascertainable during 1948 and 1949. Consequently, it held, the computations for the taxable years should stand as in accord with the facts as actually known at that time. This court affirms. *Ah Pah Redwood Company,* CA-9, 12/13/57.

Percentage depletion for slate determined. Taxpayer quarried slate which was used for building blocks. The court finds the first commercially marketable product obtained is after heating and other processes. Percentage depletion is therefore computed on the selling price of this product, not the value of the slate as it comes out of the quarry. *Southern Lightweight Aggregate Corp.,* DC Va., 12/23/57.

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

How agents are applying the new salvage and accelerated depreciation rules

by **THEODORE ROMAK**

Now that agents are examining returns filed under the 1954 Code, the practical application of the new accelerated depreciation and salvage rules is beginning to be clear. Mr. Romak, CPA with the New York office of Arthur Young & Company, discusses here some dealings he has had with agents on these problems in recent months; we think you'll find his experience helpful in your relations with agents.*

BY THIS TIME almost everyone is aware of the Service's new look at salvage value. That this new policy is being vigorously pursued is evident from reports received from many sections of the country. In the Colorado district, for example, the Audit Review Section will not clear a revenue agent's report unless it includes salvage value adjustments. Typically, 10% salvage value is set up with no change in useful life. Salvage is required for most assets except in the case of buildings and leasehold improvements.

In at least two instances a revenue agent has attempted to use the salvage value argument in reducing or eliminating entirely gain on sale of fixed assets which would be subject to Section 1231 treatment. Section 1231, which is the 1954 Code counterpart of old Section 117(j), provides, of course, that a net gain on the sale or exchange of fixed assets used in the trade or business and which have been held for six months or more shall be treated as a long-term capital gain. The Service has made no secret of the fact that it considers Section 1231 a one-way street in favor of the taxpayer and has tried to limit the use of the section through its depreciation regulations.

In a recent case a used ship, acquired in 1938, was being depreciated on the straight-line method over a remaining estimated useful life of 23 years from the date of acquisition, with a $15,000 salvage value. In 1954, the ship was sold for $200,000 with a resultant gain of $20,000. In 1954 (the year of sale), the company deducted depreciation to date of sale in the amount of $35,000. The revenue agent proposed to reduce the depreciation allowable for the year of sale by $20,000 so that there would be no Section 1231 gain. Tax counsel contended that the gain was attributable to increase in price levels and that Regulation Section 1.167(a)-1-(c) prohibits the adjustment as follows:

"Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels."

The agent rebutted by quoting the next sentence of the cited regulation which states:

"However, if there is a redetermination of useful life under the rules of paragraph (b) salvage value may be redetermined based upon facts known at the time of such redetermination of useful life."

The agent contended that insofar as the taxpayer is concerned the useful life terminated with sale; this constituted a change in the useful life so that salvage value can be readjusted to agree with sale price. A serious question exists as to the propriety of this reasoning, since it could severely restrict the applicability of Section 1231 of the Code. In the instant case, the matter was finally settled by compromise since other issues were also involved.

At this point reference should be made to *Rev. Proc.* 57-18 which was issued earlier this year by the Service to correct an erroneous interpretation of policies set forth in prior *Revenue Rulings* 90 and 91. These prior rulings announced that depreciation allowances would not be disturbed except where there is a clear and convincing basis for change. The new proclamation indicates that, if the facts of the case currently under examination furnish a clear and convincing basis for a depreciation adjustment, the adjustment will be made even though a depreciation deduction claimed in a previous return had been accepted without change upon examination.

A recent decision of the Tax Court, although involving 1939 Code years, appears to support the position taken by the Treasury Department in its Regulations under the 1954 Code with respect to the salvage question. In this decision, *Robley H. Evans*, TCM 57-156, 7/31/57, the taxpayer was engaged in leasing automobiles to a drive-it-yourself agency and computed his depreciation deduction on the inherent useful life of the automobiles (four years) with no salvage value. The Service contended that depreciation should be computed on the basis of the useful life equal to the normal period (15 months) the automobiles were retained by the taxpayer, with salvage value equal to average trade-in value of $1,375. The Tax Court agreed with the Commissioner and denied the taxpayer Section 1231 long-term capital gain treatment on the sale of the automobiles which had an adjusted basis below selling value at the time that they were sold, according to the tax return originally filed. Taxpayers who regularly realize gain on the sale of relatively short-lived assets can similarly expect to be challenged by the Service.

Despite the great emphasis on the necessity for taking salvage value into account, the Regulations state in Section 1.167(a)-8(e)(2) that where multiple-asset accounts are used a taxpayer may ignore salvage provided he customarily follows a practice of reporting all receipts from salvage as taxable income. He may continue the practice so long as it clearly reflects income.

Salvage value may be taken into ac-

count in determining the depreciation deduction, either by a reduction of the gross amount subject to depreciation, or by a reduction in the rate of depreciation. For example, if an asset costs $100, has a ten-year life and is subject to a 10% salvage value, the cost—net of salvage—is $90 and the depreciation deduction is $9 per year over the ten-year life. If a 9% rate is applied to the total cost of the asset, the same amount of straight-line depreciation of $9 per year results, so that at the end of ten years a $10 residual is left which is presumed to equal the salvage value. The Regulations clearly permit the recognition of salvage value through adjustment of the depreciation rate.

Salvage value adjustment

However, it appears that this method is applicable only with respect to straight-line depreciation. The sum-of-the-years-digits fractions which are applied to the full cost of an asset can be adjusted so that they will leave the required amount of salvage at the end of the asset's useful life. The adjustment of these fractions, however, will also alter the annual depreciation allowances and such allowances will not necessarily be the same as the annual allowances computed in the regular manner. Unless the annual depreciation allowances are the same as those which result from applying the unadjusted sum-of-the-years-digits fractions to the cost less salvage value of an asset, it is doubtful whether the Treasury Department would permit salvage value to be taken into account through an adjustment of the sum-of-the-years-digits fractions. Under the declining-balance method, salvage value is not taken into account either in the depreciation rate or by adjustment of the basis; but, under this method, depreciation must cease when salvage value is reached.

Reconstruction

The double-declining-balance method and sum-of-years-digits method of computing depreciation are available only with respect to tangible property which has an estimated life of three years or more and which is either purchased new by the taxpayer or has been constructed or reconstructed by the taxpayer. To what extent may a taxpayer make use of used or second-hand material in constructing or reconstructing a machine or a building? To take a specific case, suppose a corporation purchases an oil pipeline in 1957 which is presently located in Texas and has it dismantled and moved to a new location in Pennsylvania. Can the total cost thereof be depreciated under the accelerated methods? Depreciation regulations specifically state that it is not necessary that materials used in reconstruction or construction be acquired after December 31, 1953, or that they be new in use (Section 1.167(c)-1(a)). It is understood that at the time when the final Regulations were being drafted serious consideration was given to possible restriction of the use of used material by requiring that a substantial portion of such material must be new. However, this language never found its way into the final Regulations. Accordingly, it would appear that the answer to the above query as to availability of the new methods is "yes." On the other hand, it is possible that the Treasury Department would contend that a new pipeline has not been constructed but there has been merely a change in the location of the old pipeline. If this position were sustained, the new methods would not be applicable.

Capitalized repairs

If a revenue agent in the examination of a return capitalizes certain items deducted as repairs on the tax return, it is clear that the taxpayer may elect to depreciate the capitalized repairs by one of the accelerated methods, provided that these expenditures otherwise qualify (Section 1.167(a)-10(a)). A taxpayer may handle capitalized repairs (whether initiated by the revenue agent or not) in one of two ways. He can set up the expenditures in a separate account and elect one of the accelerated methods, in which case the unadjusted basis of any assets replaced shall be removed from the old asset account and shall be charged to the appropriate depreciation reserve account. In the alternative, he may capitalize such expenditures by charging them to the depreciation reserve account for the asset; however, by doing so he denies himself the use of the new methods (Section 1.167(c)-1(b)).

Substituted basis

In the case of an involuntary conversion, where the taxpayer replaces the property and elects not to recognize the gain pursuant to Section 1033,[1] a question has been raised as to whether the new replacement property can be depreciated under the accelerated methods. In recent *Revenue Ruling* 57-443 the Treasury Department has answered this question in the affirmative. There is nothing in the Code or Regulations to prevent the application of accelerated methods to the substituted basis of property. Thus, in a tax-free exchange of a new truck for an old truck where the basis of the new truck is equal to the adjusted basis of the old truck plus cash additionally paid, depreciation under the accelerated methods can be computed on the entire adjusted basis of the new truck.

Carryover of accelerated methods

The problem of availability of the new methods with respect to assets which are transferred in certain types of reorganizations is frequently overlooked. Section 381 specifically requires the carryover of depreciation methods in a tax-free corporate liquidation under Section 332 and in certain types of nontaxable reorganizations.[2] The section does not apply in a D type reorganization (transfer by a corporation of all or part of its assets to another controlled corporation for stock) unless the stock received is distributed to the stockholders of the acquiring corporation. Section 381 does not apply to Section 351 transactions. This means that the transferee of properties from a transferor who was using the accelerated methods may not continue to use them in transactions wherein:

1. A corporation transfers part of its properties to a new subsidiary in exchange for all of the stock of the subsidiary.
2. An individual incorporates his sole proprietorship.
3. A partnership incorporates.
4. An individual or partnership receives property in distribution upon dissolution of a corporation.
5. Property is transferred to a partnership by a partner, or vice versa.

Where a consolidated return is filed, however, transfers of property can be made between members of the group without sacrificing use of the accelerated methods. Thus, if a corporation transfers part of its properties to a new subsidiary in a Section 351 transaction, the new subsidiary can continue to use the

* This paper is based on a talk before the Federal Tax Institute, New Jersey Society of CPAs, last year. A version of it appeared in the Arthur Young Journal; it is used here with permission.

[1] Section 1033 provides for nonrecognition of gain on an involuntary conversion where insurance and other proceeds received on account of the loss are reinvested in similar property within a specified period of time.

[2] The reorganizations referred to include those covered by Section 368(a)(1)(A), (C), (D) and (F).

method adopted by the parent provided a consolidated return is filed by the group.

State tax returns

Some states may not go along with the accelerated methods for their tax reports. This can create a burdensome accounting problem since it is often necessary to maintain three sets of records, one for the books where rates or bases are different from those used on the Federal return, one for the Federal return using the accelerated method and one for state purposes. California has been very insistent that depreciation must be computed on the straight-line method or at best at 150% of the straight-line rate under the declining-balance method in its returns. New Mexico and Wisconsin also do not recognize the accelerated method.

150% declining balance method

Under the 1939 Code taxpayers were permitted to use the declining-balance method limited to 150% of the straight-line rate provided they followed the requirements as set out in IT 3818. The Service was asked about its present attitude towards use of the 150% method in view of the 1954 Code. In *Revenue Ruling* 57-352 the Service states that the 150% method may be used for assets which would not otherwise qualify for the new accelerated methods, i.e., used tangible property acquired after January 1, 1954. The method can be used without advance permission provided (a) it was elected by a new entity in an initial return, or (b) permission to use the method has previously been granted by the Commissioner, or (c) it was elected in the first return filed in which depreciation was sustained, or (d) it was elected in the return for the first year in which the property was subject to the allowance for depreciation, regardless of the method employed in computing depreciation for other depreciable property.

In recent years the organization of investing syndicates or limited partnerships to purchase developed real estate such as office buildings has become popular. One of the attractive features presented to the prospective investor is the receipt of a 10%-12% return on his investment about half of which is tax-free. This can be accomplished because the annual cash throwoff is in excess of the taxable income of the venture, since income is reduced by depreciation deductions in excess of mortgage principal amortization payments. In most cases, it is anticipated that the building will be disposed of in a relatively short period of time. These real estate ventures have found the use of the 150% declining-balance method very useful in reducing taxable income. They are denied use of the double-declining-balance or sum-of-the-years-digits methods because, in most cases, the buildings are not new.

Taxpayers desiring to use the 150% method on second-hand equipment purchased may do so by setting up the acquired assets in a separate account. Note, however, that the benefits to be derived from the use of this method often may be more apparent than real. While a greater amount of depreciation may be claimed in the early part of an asset's life, this advantage is outweighed by the fact that a sizable undepreciated balance will remain at the end of the normal life of the asset. This undepreciated balance will usually exceed normal salvage value, if any, at the end of an asset's useful life. It is clear, moreover, that a switch to the straight-line method cannot be made without advance permission. A switch without permission to the straight-line method is restricted to new assets being depreciated under the declining-balance method authorized by Section 167(b)(2).

Retirements

One of the more troublesome areas in depreciation accounting is in the handling of retirements from multiple-asset accounts. While gain might be recognized on retirements from multiple-asset accounts under the 1939 Code Regulations, loss could not be recognized where the retirement was considered to be a normal retirement rather than an abnormal retirement. The 1954 Code Regulations have made a basic change in the method of handling retirements from such multiple-asset accounts. Gain or loss may now be recognized on a disposition, (i.e., a sale or exchange of an asset) in the case of a normal retirement from a multiple-asset account (Regulations Section 1.167(a)(8)(c)(1)). Where there is a normal retirement of an asset from a multiple-asset account and the depreciation rate is based on the average expected useful life of the assets, the adjusted basis of the asset retired is the salvage originally estimated in determining the depreciation deduction. Thus, the amount of gain or loss is measured by the difference between the amount of salvage originally estimated and the actual salvage proceeds.

Old rule unchanged

The old rule which recognized losses in case of abnormal retirements from a multiple-asset account remains unchanged. The basis of the asset being retired in the event of an abnormal retirement is equal to the cost of that asset less accumulated depreciation computed under the depreciation method used for the multiple-asset account at a rate applicable to the individual asset being retired. In other words, the accumulated depreciation should be computed as though the asset had been depreciated in a single-asset account.

If a taxpayer has a large number of individual-item accounts for a category of assets, for example, trucks, and employs the same *average* useful life in determining the depreciation deduction for each item, the Regulations indicate that the taxpayer is not actually applying the item accounting concept, but is really using group depreciation. As a result, loss on normal retirement will not be recognized and the remaining basis of the asset retired will be amortized over the average total expected useful life of the asset. Thus, if a six-year life is being used to depreciate a group of trucks accounted for in separate accounts, and one truck is retired at the end of three years, the remaining basis of that truck (less salvage) is to be amortized over six years, i.e., no loss is

DEPRECIATION: LIFE BLOOD

FLEXIBILITY I regard as the most important feature in a sound system of depreciation. Whether depreciation is a cost or whether it is a deduction from selling price, it is important that it be a recovery and not a statistical increase in loss which may never be recovered. . . .

If the present furor about depreciation produces no other benefit, it has at least made many people realize that depreciation is a living thing and is not merely an accounting proration. It is a part of the life blood of industry—that is, the money flowing into and out of the business—and should be analyzed as the ebb and flood, with all their variations.—*W. L. Hearne,* Tax Supervisor, U. S. Steel Corporation, at the 13th National Tax Conference of the Tax Foundation.

allowed on retirement (Sec. 1.167(a)-8(e)).

Should an agent take the position that the taxpayer is not permitted to use item accounting, it appears that the taxpayer should be permitted to use one of the alternative methods of normal retirement accounting which apply to multiple-asset accounts. Under these alternative methods, either the full cost of retired assets can be charged to the depreciation reserve, with all receipts from salvage being credited to the reserve, or all receipts from salvage can be reported as ordinary income. ☆

Legal and prudent rules for what records to keep, and how long to keep them

by **HARRY GRAHAM BALTER**

Record-keeping is implicit under our income tax system, and the law requires that adequate records be kept. But what are adequate records? How long should they be kept? What effect does kind of business have on retention period? What is prudent, or tactfully wise, when taxpayer is in a position he may have to defend? The following article is a recommendation for tax practitioners, based on the law and the author's experience.

THE TYPICAL TAXPAYER, at the time he files his Federal income tax return, is put "on his honor"; *i.e.*, he assesses himself for what he declares his tax obligation to be. But the right thus afforded him is balanced by the correlative duty to justify the amount he assessed himself if and when his return is later subjected to audit.

It may be best to determine the area of our discussion at the very beginning by pointing out the principal by-products of this "self-assessment" system:

A statutory obligation on the part of most taxpayers to maintain adequate books and records which "clearly reflect income."

If taxpayer's records "clearly reflect income" the accounting method he adopts normally must be used by the Commissioner.

But if in the Commissioner's judgement the taxpayer's accounting method does not "clearly reflect income," the Commissioner has the statutory power to determine income by any method he finds to be more accurate.

Where the Commissioner determines additional income by methods other than that reflected in taxpayer's accounting method or his books and records, this determination is presumed to be correct.

In any later controversy which may arise between the Commissioner and the taxpayer over this determination of additional taxes, the burden of proof will be on the taxpayer to show error on the Commissioner's part.

These principles suggest some basic problems respecting the taxpayer's books and records:

1. *Which* taxpayers are required to keep books and records?

2. *What* books and records must be kept and retained by the taxpayer in order to meet statutory requirement of adequacy?

3. What records and what accounting methods would be considered to "clearly reflect income" so as to prevent the Commissioner from resorting to other sources or methods for proving additional income?

4. For what period of time must a taxpayer retain his books and records?

5. What risks does the taxpayer run if his previously kept books and records are no longer available in whole or in part when an audit of his return is undertaken at a later date?

6. Is there any "safe period" after which records may be destroyed?

Which taxpayers must keep books?

Section 6001 of the 1954 Code provides as follows: "Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, . . . and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to . . . keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title."

Regulations 118, Section 39.54-1 (a) provides as follows: "Every person subject to the tax except persons whose gross income (1) consists solely of salary, wages, or similar compensation for personal services rendered, or (2) arises solely from the business of growing and selling products of the soil, shall, for the purpose of enabling the Commissioner to determine the correct amount of income subject to the tax, keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of the gross income and the deductions, credits, and other matters required to be shown in any return under chapter 1 . . . ."

Even if a taxpayer is or claims to be in a class exempt by Regulations from the obligation to maintain books and records, he will still have the burden of proving the correctness of items of income or deductions if challenged by the Commissioner; supporting records, therefore, are needed as a practical matter.

What is adequate?

There are two practical purposes for requiring a taxpayer to maintain adequate books and records: (1) So that the taxpayer may adopt an accounting method based on his books and records which will reflect his true income when he prepares his income tax return, and (2) so that at a later date if the Commissioner audits the return, he in turn may determine whether the taxpayer's accounting method and the supporting records do in fact reflect the true income.

Now let us turn to the sources for this requirement. Section 446(a) of the Code provides: *"General rule.* Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) *Exceptions*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

This article is based on a paper by the author Harry Graham Balter, published in its entirety in the Marquette Law Rev.; this adaptation is used with permission.

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Regulations 118, §39.41-1(3) provides: "It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. . . .

"Sec. 39.41-2(a). Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . ."

A General Guide[1] issued by the Commissioner in 1956, while not having the force of statute or of a regulation, is intended to indicate what the Service believes would be the *minimum records* which taxpayers in various categories should keep for subsequent inspection by the Commissioner.

A few of the more common situations would be reflected by referring to some sections of this General Guide.

Some of the basic principles which we learn from an examination of the requirements of the statute, the Regulations and the General Guide are the following:

The taxpayer is free to adopt almost any method of accounting he chooses, as long as the method meets certain requirements, namely: (1) It must clearly reflect his income on a 12-month period; (2) It must be based on adequate records; (3) It must have been consistently used without distorting annual income; and (4) Its use cannot cause excessive administrative inconvenience or result in undue loss of revenue. (Such a situation would border closely on tax evasion).[2]

To "clearly reflect income" means that the income must be reflected with as much accuracy as standard methods of accounting permit.[3]

Since it is impossible to define these terms in general language, it has become necessary to apply them in the light of the particular case, the particular business involved, the particular methods employed in that business, and with reference to the specific items of income or deduction involved.[4]

If taxpayer's method of accounting does in fact clearly reflect income, both he and the Commissioner will be bound by it.[5]

It is significant for the taxpayer to show that his books of account or method of accounting reflect the same type of accounting employed by the vast majority of those in the same type of business or profession.[6]

The Commissioner is not prevented from disapproving the taxpayer's method of accounting as not clearly reflecting income merely because it has been regularly used for many years.[7]

The fact that taxpayer's books, records and accounting method meet requirements of other Federal or state agencies does not bind the Commissioner, who may independently determine whether they "clearly reflect income."[8]

The fact that records are complete on their face and appear to be honest and truthful does not prevent the Commissioner from determining that they do not in fact conform to an accounting system clearly reflecting income.[9]

The requirement that if taxpayer does not keep books he must use calendar year and not fiscal year basis is not satisfied by keeping of informal and fragmentary records.[10]

Where taxpayer purports to use accrual basis of accounting, his books must be adequate to clearly reflect income by that method and the test will not be satisfied if the fragmentary records he keeps more clearly reflect income on the cash basis.[11]

But the mere fact that records are simple and fragmentary does not justify the Commissioner ignoring them if under special circumstances the records in fact clearly reflect income.[12]

Where Regulations require him to keep inventories, the taxpayer will be audited on the accrual basis whether or not he has kept inventories and whether or not he has kept books on the cash basis.[13]

If not required to keep inventories and if the taxpayer has kept no books of account, the Commissioner will audit his return on the cash basis.[14]

The key to our entire problem is the power which vests in the Commissioner to ignore the taxpayer's books and records where he decides that they do not "clearly reflect income," and to resort to any accounting method or to any indirect method of proving a higher income than that reflected in the taxpayer's books.

These are some of the manifestations of the Commissioner's power in this respect:

1. He may switch the taxpayer's accounting method from the accrual or the hybrid basis to the cash basis or vice versa.

2. He may switch from the fiscal to the calendar year basis, or vice versa.

3. He may apply the *Cohan* rule of approximation where deductions are not adequately substantiated or he may disallow the deductions entirely.[15]

4. Among the more common indirect methods of proving income which he may use are the following: (a) Net worth increase,[16] (b) Cash expenditures;[17] (c) Bank deposits;[18] (d) Unit mark-up; (e) Net profit percentage; (f) Raw materials usage.[19]

Contesting the Commissioner's action

The Commissioner's action in rejecting the taxpayer's books and methods and resorting to some alternative method of determining the true income, of course, is subject to court review.

The burden of proof is on the taxpayer to show that *his* accounting method rather than the alternative method chosen by the Commissioner more accurately reflects income. In this regard, the Commissioner's action is

[1] Sec. X § GUIDE TO RECORD RETENTION REQUIREMENTS, 21 F.R. 6431; 565 CCH par. 6696 (August 28, 1956).
[2] Harden v. Commissioner, 223 F.2d 418 (10th Cir. 1955); Note 54 COL. L. REV. 1267 (1954).
[3] Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953).
[4] Bradstreet Company of Maine v. Commissioner, 65 F.2d 943 (1st Cir. 1933); Boynton v. Pedrick, 136 F. Supp. 888 (S.D.N.Y. 1954); V.T.H. Bien, 20 TC 49 (1953); 54-2 U.S.T.C. par. 966; Pacific Grape Products Co., 219 F.2d 862 (9th Cir. 1955); 1 MERTENS, INCOME TAXATION §12.05 (1956).
[5] Daley v. U. S., 243 F.2d 466 (9th Cir. 1957).
[6] V.T.H. Bien, 20 TC 49 (1953).
[7] *Ibid.*
[8] Old Colony Railroad Company v. Commissioner, 284 U.S. 552 (1931); Pennsylvania Electric Company v. Commissioner, 135 F. Supp. 416 (Ct. Cls. 1955); Gulf Power Co., 10 TC 852 (1948); National Airlines Inc., 9 TC 159 (1947); Seas Shipping Company Inc., 1 TC 30 (1942); 1954-1 CUM. BULL. 288.

further aided by judicial recognition that he must be given broad administrative discretion.[20]

The adequacy of the taxpayer's records and accounting method is a question of fact and not of law, and is subject to judicial review of the entire record.[21]

The court will test the Commissioner's action in the light of the realities of the situation, neither according to book entries a presumption of correctness nor ignoring the realities of a transaction merely because a taxpayer has failed to record it or has improperly recorded it in his books.[22]

But in resorting to methods of proving income other than that adopted by the taxpayer, especially where indirect methods of proof are utilized, the Commissioner's action will be disapproved to whatever extent it reflects a disregard of realities or an unreasonable and arbitrary attitude.[23]

However, the fact that the Tax Court modifies some of the Commissioner's adjustments does not mean that the accounting method which he used must be rejected as arbitrary.[24]

Retention of books and records

Assume that the taxpayer at one time had an adequate accounting method supported by adequate records, but when subsequent audit is made (first or successive), taxpayer no longer has adequate records, either having lost or destroyed them.

Pertinent problems suggested by this situation are:

1. Are Commissioner's powers any different?

2. Does good-faith destruction or loss of records by taxpayers affect Commissioner's powers?

3. What is period of time during which taxpayer is required to retain records?

4. What is the situation where taxpayer can produce some records—primary or secondary—but not complete records?

5. Does fact that taxpayer is engaged in illegal business impose greater duty to retain records?

6. What penalties and sanctions may taxpayer incur for not having records available at time of audit?

There is nothing in the Code specifically dealing with the retention period for books and records. However, the Regulations and the General Guide refer to the problem: Regulations 118, Section 39.54-1(a) provides: ". . . The books or records required by this paragraph shall be kept at all times available for inspection by internal revenue officers, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law."

In some few instances the General Guide specifies no retention period; in a few other cases there is indicated a specified period of time; but in the great majority of situations the same language is used as in the Regulations, namely "so long as the contents thereof may become material in the administration of any Internal Revenue Law."

This phrase "So Long as the contents thereof may become material in the administration of any Internal Revenue Law" must relate to the applicable statute of limitations for assessment: It would seem clear on the basis of this phrase that the minimum retention period must be for as long as the statute of limitations for further assessment is open as to the particular taxpayer.

But when it comes to determining how long the applicable statute of limitations may be for the particular taxpayer, we are in an area of great complexity.[25]

Special situations: We shall speak only of the more common situations involving periods of assessment for income taxes. We should point out, however, that there are numerous specific periods of time for particular types of taxpayers and particular types of taxes indicated throughout the Code.

Normal statute of limitations for assessments: The normal period of limitations for assessment of additional taxes is three years. This would then be the irreducable minimum period for retention of records.[26] Where an additional assessment is proposed by the Commissioner within what he claims to be three years after the due date of the return, the burden of proof would be on the taxpayer to show that the normal period has in fact already expired.

Statute of limitations where burden of proof is on the commissioner to show that longer than normal period of limitation applies: (a) *25% understatement of gross income*: Where there is shown to be an understatement of gross income of 25% or more, the statute of limitations for additional assessment is six years.[27] Where no valid return was filed, there is no statute of limitation barring assessments.[28] Where the return filed by the taxpayer is found to be fraudulent, there is no statute of limitations for additional assessments.[29]

Extension of limitation period by waiver: It is common practice for revenue agents to seek and obtain one or more waivers of the normal statute of limitations. It is important that the record be checked before it is assumed that the statute of limitations has in fact run against further assessments. It is unfortunate that as a practical matter, the constant obtaining of extensions has minimized the protection presumed to be afforded the taxpayer by the statute of limitations.

Request for early audit: The Code provides an opportunity for some taxpayers (usually involving executors of estates or corporations in the liquidating process) to request an immediate audit. Under these circumstances the normal statute of limitations is reduced to

[9] Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953); Boynton v. Pedrick, 136 F. Supp. 888 (S.D.N.Y. 1954); Sam Mesi, 25 TC 513 (1955); V.T.H. Bien, 20 TC 49 (1953).
[10] Louis M. Brooks, 6 TC 504 (1946); (Slips of paper kept on file and informal ledger not enough; general ledger is not a book of original entry); Malcolm G. Brooks, 5 TCM 181 (1946); Max H. Stryker, 36 BTA 326 (1937).
[11] Matter of Pinkus Newman, 94 F.2d 108 (6th Cir. 1938).
[12] Becheli v. Hofferbert, 111 F. Supp. 631 (DC Md. 1953); Frank Shinkonis, 10 TCM 503 (1951); Arthur Ward, 7 TCM 505 (1948) (Taxpayer-owner of liquor store retained simple records; revenue agent ignored these records and substituted unit mark-up permitted by state. *Held*: This was arbitrary under special circumstances; evident taxpayer did not make that much profit).
[13] Herberger v. Commissioner, 195 F.2d 293 (9th Cir. 1952); Boynton v. Pedrick, 136 F. Supp. 888 (S.D.N.Y. 1954); Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953).
[14] Greengard v. Commissioner, 29 F.2d 502 (7th Cir. 1928) *affirming*, 8 BTA 734 (1927); Fredrico Stallforth, 6 TC 140 (1946).
[15] Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).
[16] Samuel G. Malouf, 15 TCM 571 (1956); David Meade Peebles, 15 TCM 801 (1956); Epstein v. U. S., 246 F.2d 563 (6th Cir. 1957); Schwarzkoff v. Commissioner, 246 F.2d 731 (3rd Cir. 1957). *Cf.* West v. Henslee, 575 CCH par. 9932 (DC Tenn. 1957).
[17] A "cash expenditures" case normally is present as an important phase of a "net worth increase" case, rather than as an independent method of proof.
[18] Dell v. Glenn, 231 F.2d 186 (6th Cir. 1956); Lesly Cohen, TCM 172 (1957); Sam Saffren, TCM 184 (1957); Morris Miller, 14 TCM 398 (1955); Herman J. Romer, 28 TC No. 145 (1957).
[19] D & H Bagel Bakery Inc., 15 TCM 334 (1956).
[20] V.T.H. Bien, 20 TC 49 (1953); Burnet v. Houston, 238 U.S. 223 (1930); Welch v. Helvering, 290 U.S. 111 (1933); United States v. Tillinghast, 69 F.2d 718 (1st Cir. 1934); Harry Gleis, 24 TC 941 (1956); Morris Lipsitz, 21 TC 917 (1954); *aff'd*, 220 F.2d 871 (4th Cir. 1955). See Balter, *Rules of Evidence Applicable in Proceedings Before the Tax Court of the U.S.: Burden of Proof and Presumptions*, Seventh Annual Marquette University Institute on Taxation (1956).
[21] Sam Mesi, 25 TC 513 (1955); Jack Showell, 23 TC 495 (1954).
[22] Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); Commissioner v. North Jersey Title Insurance Co., 79 F.2d 492 (3rd Cir. 1935); Deer Island Logging Co., 14 BTA 1027 (1929); 1 MERTENS, INCOME TAXATION §5.09 (1956).
[23] In re Max Sheinman, 14 F.2d 323 (E.D. Pa. 1926); Rubino v. Commissioner, 226 F.2d 291 (6th Cir. 1955); O. E. Stephens, 15 TCM 1471 (1956); Sam Mesi, 25 TC 513 (1955); Jerome A. Giles, 14 TCM 742 (1955); Jack Showell, 23 TC 195 (1954); Leonard Cephus Hall, 12 TCM 1067 (1953); Arthur Ward, 7 TCM 505 (1948); Frank Shinkonis, 10 TCM 503 (1951); (unit markup rejected).
[24] Harry Gleis, 24 TC 941 (1956).

Cantrell is Treasury Counsel

ARCH M. CANTRELL has just been named General Counsel of the Treasury Department by the President. He is a lawyer, from Clarksburg, West Virginia. He succeeds Nelson P. Rose, who resigned.

eighteen months.

Amending the original return: Amending the valid original return before the applicable statute of limitations has run does not toll the limitation period; it runs from the date when the original return was due and not from the date of the filing of the amended return.[30]

Premature destruction or loss

Perhaps the most important effect of the taxpayer being unable to produce his books and records during the required retention period would be the likelihood of the revenue agent indicating in his report that the taxpayer has not "cooperated," and using this observation as a justification for "throwing the book" at the taxpayer.

The Commissioner may assert and recommend various civil and criminal penalties and sanctions: (1) The 5% penalty for negligence or disregard of the Commissioner's Rules and Regulations.[31] (2) The 50% penalty for having filed a fraudulent return. This penalty is more likely to be asserted by the Commissioner where he is satisfied that there has been deliberate destruction of preexisting records, which to his mind would indicate fraudulent intent.[32]

Either a misdemeanor charge[33] or a felony charge[34] are possible recommendations which may flow from the failure of the taxpayer to make available adequate books and records for examining Internal Revenue agent.

The agent may use every available means of determining the highest additional tax and then throw the burden on the taxpayer to upset the prima facie correctness of the proposed assessment.[35] The destruction of preexisting books and records may in itself help to relieve the Commissioner of the burden of proof which he would otherwise have where he is seeking to apply a longer-than-normal statute of limitations. For example, in the absence of books and records, the agent will be justified in using indirect methods of proving unreported income which may then indicate an understatement of gross income of 25% or more, thus permitting the six-year statute of limitations to be operative. Or if fraudulent intent can be established from the destruction of books and records and the other usual indicia of fraud, then no statute of limitations would apply. If taxpayer is engaged in an unlawful business, his duty to retain adequate records for the requisite period is stronger, although not to the point of confiscation.[36]

Right to re-examine

We must keep in mind certain basic rules respecting the Commissioner's right to re-audit the taxpayers returns and re-examine his books and records even though a previous audit had been made. A knowledge of these rules is important where adequate books and records may have been present on the first audit but are no longer present on a re-audit. Here are the governing principles: (1) The fact that a Form 870 agreement was reached between the Commissioner and the taxpayer presents no bar to a subsequent audit while the statute of limitations is still open, since this type of an agreement, not being a formal closing agreement, is not binding on either party.[37] (2) If the normal limitation period has run, subsequent examination will be permitted upon the agent's allegation that he has basis for suspecting presence of fraud without the necessity of actually showing fraud.[38] (3) Nor does previous audit prevent the agent from access to accountant's work papers or taxpayer's records in accountant's possession.[39]

What can taxpayer do?

When taxpayer has destroyed his records in such circumstances he might do one or more of the following things:

He can produce testimony or other evidence that he originally kept complete records which were accurate and honest.[40]

Prove that the same type of records now available though inadequate were used in previous years and revenue agents made no objection to inadequacy.[41]

Produce *some* available records—primary or secondary—even if not complete.[42]

Produce convincing records as to some issues or some of the years in question, even though he has no adequate records as to other issues or other years.[43]

Prove key transactions by secondary evidence—documentary or oral.[44]

Where deductions are involved, he can produce evidence that some expenditures were made or losses occurred so that *Cohan* rule may be applied as to amount.[45]

Present evidence of good faith in prematurely destroying or losing records, which may take the form of advice of others, or nontax consideration; and he may avoid inference of fraud or that records concealed unfavorable information.[46]

[25] For more detailed discussion of relation of statute of limitations to retention period, see Altman, *How Long Should Records Be Kept?* 29 *Taxes* 875 (1951).
[26] Int. Rev. Code of 1954, Sec. 6501(a).
[27] *Id.* Sec. 6501(c)(1)(A).
[28] *Id.* Sec. 6501(c)(3).
[29] *Id.* Sec. 6501(c)(2). See Balter, *Rules of Evidence Applicable in Proceedings Before the Tax Court of the U. S.: Burden of Proof and Presumptions*, Seventh Annual Marquette University Institute on Taxation (1956).
[30] Zellerbach Paper Company v. Helvering, 293 U.S. 172 (1934).
[31] Int. Rev. Code of 1954, Sec. 6653(a); Ralph Romine, 25 TC 859 (1956); Samuel G. Malouf, 15 TCM 571 (1956); David Meade Peebles, 15 TCM 821 (1956); Morris Wexler, 14 TCM 447 (1955); Estate of Albert D. Phillips, 14 TCM 516 (1955); Sam Saffen, TCM 184 (1957); 10 MERTENS, INCOME TAXATION, Secs. 5.25 & 55.28 (1948).
[32] Int. Rev. Code of 1954, Sec. 6653(b); Hall v. U.S., — F. Supp. —, 57-1 U.S.T.C. par. 9329 (D. Ga. 1956); Goldberg v. Commissioner, 239 F.2d 316 (5th Cir. 1956); John Federika, 14 TCM 652 (1955); A. J. Mandt, 14 TCM 909 (1955); Randolph Murdough, 14 TCM 974 (1955); Morris Miller, 14 TCM 398 (1955); Estate of Fred Arbogast, 7 TCM 211 (1948).
[33] Int. Rev. Code of 1954, Sec. 7203.
[34] *Id.* Sec. 7201.
[35] John Federika, 14 TCM 652 (1955); Morgan Ice Company, Inc., 9 TCM 170 (1950).
[36] Morris Wexler, 14 TCM 447 (1955); H. T. Rainwater, 23 TC 450 (1954); Springer v. Truman, 8 TCM 108 (1949).
[37] In re Wood, 123 F. Supp. 297 (S.D. Ky. 1954); Torras v. Stradley, 103 F. Supp. 737 (N.D. Ga. 1951); In re Paramount Jewelry Co. Inc., 80 F. Supp. 375 (S.D.N.Y. 1948); Boren v. Tucker, 239 F.2d 767 (9th Cir. 1956).
[38] Matter of Carroll, 149 F. Supp. 634 (1957); United States v. People's Deposit Bank and Trust Co. of Paris, Ky., 112 F. Supp. 720 (C.D. Ky. 1953), *aff'd per curiam*, 212 F.2d 86 (6th Cir. 1954); Corbin Deposit Bank of Corbin, 244 F.2d 177 (6th Cir. 1957).
[39] Schulman v. Dunlap, 105 F. Supp. 104 (S.D. N.Y. 1952); Balter, *The Accountant's Responsibility for Working Papers, Books and Records*, 32 TAXES 415 (1954).
[40] Jerome A. Giles, 14 TCM 742 (1955); H. T. Rainwater, *supra* note 36; H. H. McCoy, 5 TCM 101 (1946); *Cf.* Gamm v. Commissioner, 39 F.2d 73 (5th Cir. 1930).
[41] Randolph Murdough, 14 TCM 974 (1955); Estate of Albert D. Phillips, 14 TCM 516 (1955); (Such failure to object, however, would not be construed to be acquiescence by the Commissioner); *Cf.* Paulosky Estate, 6 TCM 1176 (1947).
[42] Jerome A. Giles, 14 TCM 742 (1955); Aaron Samelson, Executor, 10 BTA 860 (1928); Ettenson Winnig Dry Goods Co., 3 BTA 897 (1926); *Cf.* Torrey v. Commissioner, 84 F.2d 659 (6th Cir. 1936). See Balter, *Rules of Evidence Applicable in Proceedings Before the Tax Court of the United States: Burden of Proof and Presumptions*, Seventh Annual Marquette University Institute on Taxation (1956).
[43] Ettenson Winnig Dry Goods Co., *supra* note 42.
[44] Aaron Samelson, Executor, 10 BTA 860 (1929); Ettenson Winnig Dry Goods Co., 3 BTA 897 (1926); 9 MERTENS, INCOME TAXATION, Secs. 50.76 & 50.78 (1943).
[45] Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930); John Federika, 14 TCM 652 (1955); Jack Showell, 23 TC 495 (1954).
[46] *Cf.* Harry Ralph Leacock, 6 TCM 1282 (1947); H. T. Rainwater, 23 TC 450 (1954).
[47] Grace O. Dean, 14 TCM 959 (1955); Jerome A. Giles, 14 TCM 742 (1955).
[48] TAX IDEAS para. 7014 & 7008.2(8).
[49] *Id.* par. 7008, 2(8).
[50] I.T. 3866, 57-2 CUM. BULL. 68 (1957).
[51] *Los Angeles Times*, Sept. 3, 1957.

He can show that the Commissioner's determination is unfair, arbitrary, and unreasonable on basis of realities of the situation or such evidence as was available to Commissioner.[47]

What, then, must be considered a "safe" retention period so that if he is unable to produce pre-existing books and records on an audit subsequent to his retention period, the taxpayer would with reasonable certainty avoid the difficulties to which we have referred?

We suggest the following guides:

The retention period must be at least as long as the period of the statute of limitations which would apply to the particular taxpayer under the facts as he knows them to exist—which, as a practical matter, he would be presumed to have known.

The retention period should be longer than indicated by the normally applicable statute of limitations, if the taxpayer himself is involved in a special situation where the tax impact of the transactions would indicate that the supporting records should be made available for a period beyond the normal statutory period.[48]

By way of illustrating where this guide may be applicable, we should mention: (a) basis situations, such as March 1, 1913 valuation, capital gains, nontaxable transactions; (b) installment sales; (c) allocations between tax years; (d) carryforward credits; (e) loss corporations; (f) worthless debt chargeoffs; (g) any transactions between the taxpayer and "related" or "controlled" taxpayers within the meaning of the Code.[49]

If filing a claim for refund, or subsequent litigation, is contemplated, whether initiated by the taxpayer or the Commissioner, then the retention period should be for so long as reference to records may be needed.

Adequate storage space

It is understandable that inadequate storage space may constitute a recurring incentive to destroy old books and records. To some extent this pressure may be alleviated through the aid of the most modern bookkeeping and record-keeping equipment. It should also be remembered that the Commissioner permits the microfilming of supporting records.[50]

And finally, the harassed taxpayer may derive some comfort from the fact that the Government itself also has its record storage problems. Original tax returns normally are destroyed after six years, although no doubt they have been microfilmed. And only recently the Defense Department has placed a Rear Admiral in charge of a new "Office of De-Classification" to reduce the backlog of an estimated billion or more "secret documents" which have been accumulating since Civil War days.[51] ☆

Fight looms over line IRS draws between advertising and lobbying expenses

THE ADVERTISING WORLD was thrown into something of a turmoil a few weeks ago when one of the advertising trade papers reported that the IRS "has rejected a protest by the Advertising Federation of America against a Treasury Department ruling going into effect this year. The ruling will no longer allow businesses to deduct expenditures for institutional, educational and long-range advertising from the cost of doing business. Public utilities particularly will be affected. . . ."

The language in this news story seemed a little unlikely to your editors. On checking with the IRS, we learn that the prohibition against deductibility applies only to expenditures for influencing legislation, and that this language, borrowed from the old charitable institution Regulations, is contained in Par. 1.162-15(c) of proposed Regulations to Section 162 issued in 1956.

The language of the proposed Regulation and the advertising industry's alarmed and vocal response to them is one indication that a line is being drawn between lobbying and ordinary advertising expense. A more recent sign of the Treasury outlook is the Kefauver-Harrington correspondence revealing an IRS stand against private power advertising against public power.

The proposed Regulations

The proposed Regulations under the 1954 Code contain these paragraphs (Par. 1.162-15(c)):

"Expenditures for lobbying purposes, for the promotion or defeat of legislation, for political purposes, or for the development of exploitation of propaganda (including advertising other than trade advertising) relating to any of the foregoing purposes, are not deductible from gross income. No payment made, either directly or through any organization, for the specific purpose of attempting to promote or defeat legislation shall be deductible. Other payments, not so made and otherwise meeting the requirements of the Regulations under Section 162, when made as dues or contributions to a trade or business organization, may be deductible under some circumstances, even though influencing, or attempting to influence legislation is incidentally involved in the use by such organization of such payments. Thus, the payment of such amounts made as dues or contributions to—(1) A labor, agricultural or horticultural organization, except under Section 501(c)(5), or (2) A business league, chamber of commerce, real estate board, or board of trade, exempt under Section 501(c)(6), for the furtherance of the general purposes and program of such an organization in promoting the common economic interests represented, shall be deductible in full if the activities of such organization which consist of lawfully attempting to promote or defeat legislation are incidental to the organization's general purposes and program."

The Advertising Federation of America is alarmed over the broad language of this regulation, Printers Ink reported in February, quoting AFA chairman, Robert Feemster:

"American companies spend up to $1 billion annually on advertising with the very legitimate purpose of protecting their business interests or creating their corporate images. Who is to interpret what constitutes valid institutional or image advertising? What are the limitations on the phrase 'including advertising other than trade advertising?' "

Mr. Feemster and AFA president C. James Proud wrote to the Commissioner recently, expressing concern over the regulation. An IRS staff man replied, and refused to give the federation a private hearing. He said the Service is making "every effort" to put the regulation into effect "at an early date."

Anti-public-power advertising

Senator Kefauver had been critical of the IRS last year, saying that it ought to disallow the cost of anti-public-power

advertising run by private utilities; he charged that the campaign was in reality political propaganda against the Hells Canyon project and should be treated as lobbying.

In making public a letter to him from Commissioner Harrington, saying that such advertising will be disallowed, the Senator said: "I have been studying the private power company advertising techniques for some time now, and the Bureau of Internal Revenue (sic) is entirely justified in its decision. . . .

"The advertising in question is nothing but political propaganda, pure and simple. The latest series of such advertisements were all based on taxes. . . .

"They continually attack Government appropriations for dams and steam plants.

"They equate public power and socialism.

". . . They can continue to propagandize as much as they want in their advertisements—they are merely going to have to pay the bill themselves. They can no longer charge the taxpayers. . . ."

The utilities' side of the argument was immediately publicized by Charles E. Oakes, speaking for the Edison Electric Institute. He said: "Private electric utilities . . . should be allowed to use advertising to meet any competitor, even when that competitor is the Federal Government. Moreover . . . the cost of such advertising should be deductible as an ordinary business expense. . . .

"In our mixed economy, nearly every industry is affected either by direct Government competition or by Government spending and tax policy, which tend to subsidize or otherwise benefit competitive industry. Further encroachment by Government can only be prevented by an informed and aroused public opinion. This requires the use of communicating media such as advertising. . . .

"According to the Hoover Commission report, Government facilities pay little or no interest on the invested capital, seldom charge depreciation, pay taxes only in a few instances and do not pay the fringe benefits of Government personnel.

"This is the kind of information contained in the electric utilities' national advertising program, now under attack and now subjected to the penalty of loss of tax deductibility.

"Advertising expense is most frequently incurred to assist in meeting competition, and such advertising is held to be a proper business expense both for corporate and tax purposes. It should make no difference whether the competition is from other business enterprises or from the Federal Government.

"In the case of the electric utilities, it is recognized that they may properly spend money to advance their position competitively in the sale of electricity versus gas, and such expenditures are allowed for tax purposes.

"But the impact of gas competition is certainly minor in comparison with the competition that comes into play when the Federal Government enters the power generating business and takes for itself the advantage of not paying Federal income taxes, and the further advantage of utilizing the credit powers of the national Government to obtain money at low rates not possible for the normal business enterprise." ☆

Withheld dealers' reserves not income: another circuit lines up against the Tax Court

by **ARNO HERZBERG**

With the Fifth Circuit's decision in the Texas Trailercoach case (see page 214.—Ed.) opposition to the Commissioner and the Tax Court is strengthening. Dealers who finance sales with institutions that withhold from them part of the sales price as a margin against possible defaults by the customer-buyer are happy that another court sees the inequity of taxing them on income they don't have. Mr. Herzberg, Newark, N. J., CPA who has been following this controversy with particular attention, analyzes this most recent case and considers the possibility of a reversal of policy by the Commissioner or new legislation. In any event, affected dealers should be filing claims for refund of tax they paid on the Commissioner's theory.

THE CONFUSED PROBLEM of dealers' reserves[1] is one step closer to an agreeable solution. In a very thorough analysis of the issues involved, the Fifth Circuit[2] comes to a conclusion that might turn the tide so far running against the taxpayer.

Although installment financing has been the backbone of our post-war economy, frequently interpretation of the facts of a finance deal has been at odds with the realities. The Commissioner[3] and the Tax Court[4] have again and again maintained that a dealer on the accrual basis has to report as income any reserves in the year they are credited to his account. Only the Fourth Circuit[5] and now the Fifth Circuit have taken a position that is in line with economic realities and necessities.

The pattern of financing

These are the facts involved in a typical case of installment financing:

1. The dealer sells a car only if the finance company approves the customer's credit and agrees to accept his note;

2. The customer executes the note to the finance company on forms supplied by the finance company;

3. The dealer assigns the conditional sales contract made out on forms given to him by the finance company to the finance company in consideration for the balance of the purchase price to be paid to him by the finance company;

4. The finance company might retain part of the balance due to the dealer. This retained part is called a holdback;

5. The finance company "sets aside" a portion of the finance charge as an inducement to the dealer to give business to the finance company; this contingently credited commission called reserve is not withdrawable but goes into a pool which is not paid to the dealer until and unless it reaches a certain percentage of the total outstanding customers' notes;

6. Losses are charged against holdbacks and reserves. The reserve is decreased also by a proportional reduction of the portion of the contingent commission originally set aside by the fi-

[1] See this author's articles in 5 JTAX 280 and 6 JTAX 201.
[2] Texas Trailercoach, Inc., 27 TC 575, rev'd CA-5, 1/7/58; same court in West Pontiac, Inc., rev'd 27 TC 749, 2/6/58.
[3] GCM 9571, CB 1931 153; Rev. Rul. 57-2, IRB 57-1.
[4] Shoemaker-Nash, Inc., 41 BTA 417; Royal Motors, Inc., P-H TCM §45,255; Albert M. Brodsky, 27 TC 216; Texas Trailercoach, Inc., 27 TC 575;

nance company if the notes are paid off by the customer ahead of time.

The Fifth Circuit sets a precedent

These facts are properly and adequately interpreted for the first time in the decision of the Fifth Circuit in *Texas Trailercoach*. Leaning strongly on language used in this author's articles, the Fifth Circuit calls financing a "three-way agreement with dealer, customer and finance company all parties to one single transaction." The Commissioner and the Tax Court relied and are relying on the old analysis of two contracts, each of which involves two parties only: the sales contract between the dealer and the customer, and the discounting by the dealer and the finance company.

The *Texas Trailercoach* case involves a holdback, but it is nevertheless applicable to reserves (contingently credited commissions). The dealer assigned and guaranteed contracts to the finance company, which withheld 5% of the balance of the sales price (evidently not 5% of the face value of the note). The aggregate of these holdbacks was not payable to the dealer unless it exceeded 15% of the balance due on all outstanding contracts assigned by the dealer to the finance company. But even if his required percentage was in order, the finance company was under no obligation to make payments to the dealer if he had any other obligations to the finance company; and even if he had no such obligation, the excess amounts were payable only "from time to time as determined by the finance company." In addition, the finance company had the right to charge against the account any sums the dealer might, at any time, owe to the finance company in any connection whatsoever.

The Fifth Circuit clearly and correctly states that under these conditions the dealer need not accrue a holdback in the year the sale was made. He had no right to the holdback and might never acquire a right to it. The court goes to the heart of the problem by saying: "The real trouble in this case is that the taxpayer is asked to pay a tax on money he did not in fact receive and had no right to receive during the taxable year in question. He may never receive it, but he is asked to deplete his cash in order to pay [tax on] it. If compelled to pay, the more business he does—the worse off his cash position will be."[6]

The court distinguishes the facts involved in the normal financing of a trailer from the very rare "peddling"[7] of the notes by a dealer. In the second situation, the dealer's sale of a trailer to an individual purchaser may be a complete transaction[8] separate from the discounting of the notes. In such a situation, especially if the dealer's reserve is subject to only a few restrictions, the entire sales price is income and no deduction is allowed for the finance company withholding. In this situation, amounts credited to the reserve are in effect accruable to the dealer in the period the sale was made and the holdback retained or the reserve contingently credited.

Will Commissioner abandon position?

The decision of the Fifth Circuit follows the pattern set by the Fourth Circuit—but in a more detailed and sweeping manner. It is in accord with the fundamental principles of accrual accounting, but it remains to be seen whether the Commissioner and the Tax Court will adhere to their old, now rather shaky position, and tax reserves in the year the sale was made. In a letter to this writer (dated August 15, 1957) the Commissioner stated that the decision of the Fourth Circuit in the *Blair Johnson* case was not accepted by the Government. Certiorari was not requested by the Solicitor General because there was no conflict between the decision of the Fourth Circuit and that of another circuit or the Court of Claims. At that time the Commissioner evidently did not foresee the Fifth Circuit decision against the Government; probably he thought that a conflict between circuits might develop which would make an appeal to the Supreme Court possible.

With this possibility now out of the way, the Commissioner should abandon the position he has held for more than 25 years. His reasoning has now been rejected by two Courts of Appeal. In such a situation, it is the declared policy of the IRS to comply with the courts' decisions.[9] A clue to the Commissioner's reaction will come in cases now pending before the Tax Court.

At any rate, it will be advisable to file protective claims for refund in all cases where taxes have been paid on reserves and holdbacks at the time the deals with the customers were concluded.

The problem of reserves has been the subject of proposed legislation now pending before Congress. HR 9481 is now before the House Ways and Means Committee. This bill would permit exclusion of reserves from gross income if they are not paid or made immediately available to the dealer by the finance company. This writer testified on January 24, 1958 before the House Ways and Means Committee. He favored, under certain conditions, the adoption of such a bill, which would resolve many problems and relieve the taxpayer of expensive litigation. The Government would not be deprived of any tax, because at the time the contingent credit becomes a fixed and ascertainable obligation of the finance company, the taxpayer would be required to include this amount in his tax return. ☆

West Pontiac, Inc., 27 TC 749; Burl P. Glover, P-H TCM §57645; J. H. Schaeffer, P-H TCM §57,068; John R. Hansen, P-H TCM §57,113.

[5] Blair Johnson, 233 F.2d 952, 49 AFTR 1363 (1956) *rev'g* 25 TC 123.

[6] See my identical argument 6 JTAX 281.

[7] This expression first used in 6 JTAX 202.

[8] This distinction first made in 6 JTAX 201.

[9] Statement of the Chief Counsel for IRS to Subcommittee of the Committee on Appropriations.

New accounting decisions this month

Ordinary income on contract cancellation. Taxpayer had a contract with another utility in the area under which each sold surplus power to the other from time to time. TVA acquired the properties of the other utility and taxpayer agreed to accept a cash payment and to cancel this contract. The payment was based on taxpayer's net earnings under the contract projected over the balance of the term. Distinguishing the cases which have held payment for cancellation of a lease capital gain, the court holds the payment is ordinary income. It merely represents an anticipation of the estimated profits taxpayer would have earned under the contract. *Appalachian Power Co.*, Ct. Clms., 1/15/58.

Depreciation not allowable for property not used in business. Taxpayer foreclosed on the property of a corporation of which he was the principal stockholder. He allowed the corporation to continue to use the property without paying rent. The court disallows taxpayer a depreciation deduction as the

property was used, not in his business, but in the corporation's business; nor was it used for the production of income. *Yeager,* DC Ky., 12/2/57.

Can amortize leasehold improvements over term of lease with no renewal rights. Taxpayer constructed a grain elevator at a cost of over $300,000 on leased premises covered by a five-year lease with no renewal clause. The Commissioner contended the improvements should be written off over their useful life, apparently on the ground that the substantial amount invested indicated the lease would certainly be renewed. The court rejected this view, holding for taxpayer. *McWilliams,* DC Ill., 1/9/58.

Fifth Circuit holds dealer's finance company holdbacks not income. The Fifth Circuit reverses the Tax Court and concurs with the Fourth (*Blaine Johnson,* 233 F.2d 552), that a taxpayer who finances his installment sales with a finance company is not required to include in income the proceeds retained by the finance company in a dealers' reserve account against which the finance company has the right to charge defaults by the dealer's customers. This court says the Tax Court is in error in treating the sale and the financing as two separate transactions with the dealer taxable on the full sales price and denied any deduction for the finance company withholding since no loss has yet occurred. This court sees the sale of the trailer as a three-cornered transaction; the dealer's proceeds are not the total price to the purchaser but rather the amount paid him by the finance company. In view of the power of the finance company, both as a practical matter and as set out in the contracts, to retain the holdbacks and to make charges against them, the amount reserved is not accrued income of the taxpayer until released to him. *Texas Trailercoach, Inc.,* CA-5, 1/7/58. Similarly, *Hines Pontiac,* DC Tex., 12/17/57 and *Modern Olds., Inc.,* DC Tex., 12/17/57, *West Pontiac, Inc.,* CA-5, 2/6/58. [See also page 212.—*Ed.*]

Bonus not income till available [*Acquiescence*]. The Tax Court finds that taxpayer's 1946 bonus was not unqualifiedly subject to his demand until January, 1947. The employer, a corporation with office in China, telegraphed its New York bank to send the payment to taxpayer's bank in Oregon. The credit was not received by the Oregon bank until 1947 and the item was not income to the taxpayer prior thereto. *Hennigsen,* 26 TC 528, *acq.* IRB 1957-49.

Interest on Series E bonds not taxable when they're put in trust. Taxpayer owned Series E bonds; he had not reported increment in value on prior returns. The IRS rules that the increment need not be included in his income in the taxable year in which he transfers the bonds to a revocable personal trust. The Code provides that taxpayers who elect not to include the interest increment each year must include it at redemption or maturity. Since this trust is revocable, taxpayer is regarded as the owner of the corpus and therefore is treated as not having realized income on the transfer. *Rev. Rul.* 58-2.

DEDUCTIBILITY

Corporate officer fails to prove he had costs for diverted corporate sales. Decedent was the sole stockholder of National Thread Co. from 1916 until 1944, when she transferred all her stock to her husband. Sales of over $156,000 made by him as an individual during the years 1942-45, as well as some $22,000 of unidentified bank deposits in his and decedent's name, were held to be in substance sales of National Thread and taxable to it. The proceeds were also held to represent distributions in the nature of constructive dividends to decedent and her husband, taxable as ordinary income to the extent of the corporate earnings and profits. Taxpayers do not challenge this finding, but raise the issue that the goods for which sales were omitted were paid for by them, not by the corporation, and they should be given a deduction for the cost of these goods. The Tax Court dismissed the contention, the evidence being insufficient to support it. This court affirms. *Stein Estate,* CA-2, 1/6/58.

No deduction for destruction of assets acquired to eliminate competition. Taxpayer, a general title abstract company, acquired all the records of its competitor in 1929. The records were never used by taxpayer in preparing title abstracts, nor were they kept up to date after the purchase. When the records were destroyed in 1951 upon microfilming the principal ones, the company claimed an abandonment loss. It said it had purchased them as "standby records"; the Commissioner argued the purchase was merely to eliminate competition. The court denies the loss, holding that the purpose was to eliminate competition, and resulted in a nondepreciable continuing benefit. The portion of the cost allocable to standby, if any, was so small as to be negligible. *Dane County Title Co.,* 29 TC No. 68.

"Expenses" to victorious party after stockholders' suit disallowed; corporate benefit not shown. A corporation incurred litigation expenses pursuant to a consent decree in connection with a stockholders' suit. It had paid fees to its attorney of record as well as the attorneys of record of the minority stockholders. Those fees were allowed as a deduction. However, after the minority stockholders obtained control under the terms of the decree, the corporation paid $10,000 to a law firm of which one of the minority stockholders was a member, and $10,000 to a member of another stockholders' group to compensate them for "services rendered" in the lawsuit. The court denies the corporation a business expense deduction for the additional fees since it was not shown that the "services" were rendered for the benefit of the corporation. *Royal Cotton Mill Co.,* 29 TC No. 84.

Rule on deductibility of losses in searching for new business will not be applied retroactively. *Rev. Rul.* 57-418, which allows a deduction for expenditures incurred in search of a prospective business only if the taxpayer actually enters into the transaction and then abandons it, will not be applied retroactively to losses sustained before 9/23/57, the date of publication of the ruling, nor to losses sustained after that date if the search began prior thereto. *Special Announcement,* 1/20/58.

Payments were for assets, not services. A small loan corporation sold its loan office to taxpayer-manager for his long-term promissory notes. The corporation loaned taxpayer money and guaranteed the small loan obligations without additional charge. The court holds that the installment payments by taxpayer on his notes are capital investments, not deductible payments for services of the corporation. *Clark, Jr.,* TCM 1958-10.

Deduction allowed for reimbursement to foreign agent for entertainment. Taxpayer, an American travel agency, paid

the manager of its Norwegian affiliate for expenses incurred in accommodating and entertaining the agency's clients. The Commissioner disallowed the deduction on the ground that the recipient was not taxpayer's employee and the payment was really to maintain the goodwill of the affiliate. The court finds that the payments were for reimbursement, were ordinary and necessary expenses, and are deductible. *Bennett's Travel Bureau, Inc.* 29 TC No. 38.

Can deduct payment to another to fulfill future service obligation [*Acquiescence*]. Taxpayer, on the accrual basis, went out of the television servicing business and agreed to pay another firm some $200,000 to complete its unexpired contracts after May, 1951. Taxpayer is permitted to accrue the full amount as a deduction as of May 31, 1951, the end of its fiscal year. *Bressner Radio, Inc.*, 28 TC 378, *acq.* IRB 1958-3.

WHAT IS INCOME

Refundable membership fees not income until appropriated as dues. The owner of a swimming school, wishing to build a new pool, organized a club, the initial membership fees in which would be refunded at the end of five years. However, should any members fail to pay their ordinary annual dues, the deficiency would be deducted from the refund due. The IRS rules that the initial fees are in reality loans and become taxable income only to the extent the fees are applied to satisfy delinquent membership dues. *Rev. Rul.* 58-17.

Cost-of-living allowances are taxable. Territorial cost-of-living allowances paid from nonappropriated funds to civilian employees under Armed Forces' jurisdiction at installations in U. S. territories and possessions, are includible in the recipient's gross income. *Rev. Rul.* 57-591. Similarly, cost-of-living allowances paid from appropriated funds to National Guard civilian personnel stationed in U. S. territories are subject to tax where the basic compensation is fixed by administrative order and not by statute. *Rev. Rul.* 57-592.

Promissory note had no value [*Acquiescence*]. For services rendered, a cash basis taxpayer received in 1951 a $7,000 unsecured noninterest bearing promissory note payable "240 days thereafter." At time of issuance, the maker of the note was without funds. Taxpayer was in need of immediate cash during the year of receipt and on 10 or 15 occasions attempted to sell the note but without success. The court concludes the note had no fair market value in 1951. *Williams*, 28 TC No. 144, *acq.* IRB 1958-3.

Interest on installment notes for equipment sold to states is tax exempt. [*Acquiescence*]. Taxpayer sold equipment to Kansas and Missouri and political subdivisions. It claimed that interest included in installment sales was tax exempt. The court agrees as to those written contracts which specifically provided for interest. The court was not convinced by the Government argument that such installment contracts were illegal under the state "cash basis" law. If contracts are fully executed and no fraud exists the Tax Court policy is to give them effect. The burden is on the government to prove that they were illegal. *Newlin Machinery Corp.*, 28 TC 837, *acq.* IRB 1958-3.

Automobile received for furnishing information is compensation. Taxpayer furnished a corporation with information as to possible customers. Later that same year the corporation presented him with a Cadillac automobile. The court concludes from the fact that the corporation treated the payment as a business expense and reported it on a Form 1099 that there was no donative intent. It holds the value of the automobile constitutes compensation which should have been included in taxpayer's gross income. *Duberstein*, TCM 1958-4.

OTHER DECISIONS

Liquor dealer can't deduct contributions to anti-prohibition group. Taxpayer, a liquor wholesaler, contributed to an association organized for the purpose of conducting an advertising campaign to persuade Arkansas voters to vote against a proposed state prohibition act. The Tax Court held this was lobbying and not an ordinary and necessary business expense. This court affirms. *F. Straus & Son, Inc. of Ark.*, CA-8, 1/24/58.

Loss carryover of inactive corporation not available to new owners. Section 382(a), 1954 Code, provides that the new owners of a loss corporation which changes its business may not have a loss carryover. Taxpayer requested advice on whether the loss carryover of an inactive general insurance corporation would be available if the stock was purchased by an individual engaged in the same line of business and thereafter the individual's business was done by the corporation. The IRS rules that the carryover is not available because an inactive corporation has no business; any business it goes into is a change. *Rev. Rul.* 58-9.

Government took over buses; compensation ordinary income when received. During 1944-45, when negotiations with the union became deadlocked, the U. S. took over control of taxpayer's transportation system. After Federal control ceased, taxpayer unsuccessfully sought compensation from the Office of Defense Transportation. In 1948, Congress established a commission to study the situation, and in 1952 taxpayer received $29,000 from the U. S., based upon an award determined by the commission. The Tax Court held the full amount was accruable in 1952. At no earlier time was there certainty that taxpayer would receive compensation. The award was ordinary income, not, as the taxpayer argued, capital gain on an "involuntary conversion." The property was not taken and converted; it was merely used. The award was a substitute for rental. This court affirms. *Midwest Motor Express, Inc.*, CA-18, 1/15/58. Similarly, *Gillette Motor Transport, Inc.*, TCM 1958-22.

Conversion of 2¾% Treasury bonds discussed. The Service outlines the tax consequences of a conversion of nonmarketable 2¾% Treasury bonds, Investment Series B of 1957-80 into 1½% five-year notes, and the subsequent sale of the notes. *Rev. Rul.* 57-535.

Can deduct circulation expense despite book deferral. Circulation expenditures may be currently deducted by an accrual basis taxpayer, even though such expenditures are reflected on the books and financial statements as deferred expenses. The Code, in permitting the deduction, makes no mention of book treatment. *Rev. Rul.* 57-526.

Bargain rental to stockholder treated as dividend. The excess of fair rental value of an apartment occupied by a stockholder in a building owned and operated by a corporation for profit, over the amount of rent paid, is a dividend to the stockholder. *Rev. Rul.* 58-1.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA
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Are bad debt reserves "property" in a 12-month liquidation?

by **RALPH BREAREY**

Although Section 337 provides that a corporation liquidating within 12 months has no gain or loss on property sold or exchanged in that period, the IRS has been insisting (and now has issued a published ruling: Rev. Rul. 57-482) that unused bad debt reserves be returned to income by the liquidating corporation and has been assessing ordinary income tax. Mr. Brearey, tax manager in the Washington, D. C., office of Arthur Anderson & Co., points out that a sizeable tax may arise in these "tax-free" liquidations, particularly if the Commissioner applies this theory to other types of reserve. He reviews the legislative history of Section 337 and concludes that the IRS position is unwarranted.

SECTION 337 was enacted by Congress in order to clarify the confusion that had existed by reason of the decisions of the Supreme Court in the *Court Holding Company* (324 U. S. 451) and *Cumberland Public Service Company* (338 U. S. 341) cases. It was the definite intent of Congress not to impose a double tax, once at the corporate level and again at the shareholders' level. The language of Section 337 is so clear as to leave no doubt that one tax only should be asserted and that tax should be at the shareholders' level.

The relevant parts of Section 337 provide: "General rule.—If (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and 2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims . . . then no gain or loss shall be recognized to such corporation from the sale or exchange by it of *property* within such 12-month period." (Italics supplied.)

Section 337 was intended as a solution for the problems raised by the decisions in *Court Holding Co.* and *Cumberland Public Service Co.* In doubt cases, the question was whether the corporation or the shareholder effected a sale of property in connection with the liquidation of the corporation. In *Cumberland Public Service Co.*, a distribution of property in liquidation of a corporation followed by its sale made in fact by its shareholders resulted in a single tax imposed at the shareholder level. Where the shareholders did not in fact effect the sale, as was found in *Court Holding Co.*, tax was imposed both at the corporate and at the shareholder levels.

The intent of Congress is shown in enacting Section 337. The Senate Finance Committee's report on the 1954 Code says in part: ". . . Accordingly, under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in Section 337 to provide a definitive rule which will eliminate the present uncertainties . . ."

Despite the clarity of the words of the Code and of the intent with which Congress adopted them, the IRS now claims that it finds taxable income in very typical Section 337 liquidations. The case I wish to discuss here is quite similar to the one analyzed in *Rev. Rul.* 57-482 printed in full in the box on page 000. The corporation being liquidated was a bank, X. It had used the reserve method for reporting its bad debts and the credit balance of the reserve for bad debts on its books on June 30, 1956, was $60,000. This reserve had been accumulated since 1947. The face value of loans receivable against which the reserve was accumulated was in excess of $9,000,000.

During the early part of June, 1956, taxpayer bank entered into agreement with competitor bank under the terms of which the competitor bank agreed to acquire all of taxpayer bank's assets in exchange for the assumption by the competitor bank of all taxpayer bank's liabilities and the payment of $3,000,000 in cash. By the end of August, 1956, taxpayer bank had carried out its plan, completed its liquidation, and distributed the entire sale proceeds to its shareholders in complete redemption of their stock. Taxpayer bank filed its final return for short period ended August 31, 1956, and dissolved.

Competitor bank, as sole purchaser of all the assets of taxpayer bank, listed the outstanding loans receivable in the minutes of its Board of Directors as having been acquired at face value and the loans receivable were recorded upon its books at that amount. The market value of the outstanding loans receivable was considered to be face. Thus, as purchaser of all the assets of taxpayer bank, competitor bank did not reflect the taxpayer bank's reserves on its books.

In its final return, taxpayer bank did not restore to income the $60,000 balance in its reserve for bad debts.

However, upon examination of final return of taxpayer bank in the field, the revenue agent did restore to income the credit in the reserve for bad debts. Exception was taken thereto and as a result technical advice was requested of the Service in Washington.

IRS position

In conference, the Service sustained the position taken by the revenue agent in restoring to income of the taxpayer bank in its final return the reserve for

bad debts and taxing it as ordinary income at 52%. To support this position, the Service said:

1. It is not unmindful of the rule of Section 337 that if within a 12-month period all assets of a corporation are distributed in complete liquidation, no gain or loss shall be recognized from the sale or exchange by it of its *property* within such 12-month period. (Italics supplied.) But,

2. The reserve for bad debts is not property within this section of the Code. And,

3. The taxpayer bank having had the credits to the reserve for bad debts as a tax deduction from the inception of such reserve, must be taxed on such remaining credit in the reserve for bad debts upon final sale of its assets followed by complete liquidation.

Though there was only a single transaction, namely the sale of all assets, the Service by this reasoning is divorcing one aspect of the transaction and subjecting it to a different tax treatment, on the theory that a reserve for bad debts is not property within the statute. It might be well to take a closer look at what in reality is property under the statute. Section 317(a) of Subchapter C of the 1954 Code defines property as follows: (a) "Property.—For purposes of this part, the term 'property' means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock.)"

From the foregoing, how then can it be truthfully said that a reserve for bad debts is not property within the above-cited sections of the Code? It must be remembered that the reserve for bad debts is an evaluation account measuring in fact the current face value of the loans receivable.

In further support of the position that the reserve for bad debts is property falling within the ambit of Section 337 *supra,* let's review for a moment the Commissioner's theory. In one breath, the Commissioner's representatives say the reserve is not property, but in taxing it even under the Commissioner's theory it is considered property. The yardstick which the Commissioner's representative used for measuring the income thus arising was the difference between the face amount ($9 million) received for the loans receivable and the book value of the loans. This difference equals the credit in the reserve. The Commissioner's representatives by their own acts have made an adjustment to basis within the meaning of Section 1016 of the Code. Having done so, the reserve for bad debts has to be considered property.

The Commissioner's action in taxing the credit in the reserve for bad debts must come under Section 61 of the 1954 Code, which defines gross income. Subparagraph 3 of Section 61(a) provides:

(a) "General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (3) Gains derived from dealings in property."

Let's look for a moment at the Commissioner's representative's third issue, namely, that the taxpayer bank has had a tax deduction for the years in which the reserve for bad debts was in existence. Admitting, for the sake of argument, that this is a fact, Section 337 is not concerned with what has occurred; it addresses itself to the tax effect when all assets of a corporation are sold and, within a period of 12 months from the adoption of a plan of complete liquidation, are distributed. In this specific case the statute provides that no gain or loss shall be recognized to such corporation from the sale or exchange by it of property. The statute itself grants the relief sought, namely, that the tax can be asserted only at the shareholders' level.

The reserve for bad debts is property within the statutory definition of Section 317(a). It is property under Section 1016, since the method of computing the addition to income involves a reduction in basis of the loans receivable. It is property, otherwise it could not be considered a part of gross income under Section 61 of the Code. Having satisfied all statutory provisions, how then can it be said that a reserve for bad debts is not property for the purposes of Section 337, which provides for one tax at the shareholders' level?

Interpretation of Section 368

Section 368(a)(1)(A), (B), (C) and (D) sets forth technical definitions relating to nontaxable reorganizations. Assume for a moment the facts set forth in the above taxpayer bank's case are the same except that the competitor bank, in lieu of making a cash purchase, exchanges its stock to the taxpayer bank in exchange for its assets, and assumed the liabilities of the taxpayer bank. This kind of transaction comes squarely within 368(a)(1)(C) type of acquisition and should be considered nontaxable.

Recently the writer on behalf of the acquiring competitor bank requested the Commissioner to rule on the above type of transaction. A favorable ruling was prepared, holding the above transaction tax-free under Section 368(a)(1)(C), and no taxable gain or loss recognized under Section 354, etc. However, the Commissioner's representatives insisted that the ruling contain a paragraph to the effect that to the extent the transferor bank had a credit in the reserve for bad debts, at date of acquisition by the

COMMISSIONER RULES UNUSED RESERVE INCOME, THOUGH LIQUIDATION TAX-FREE

IN ACCORDANCE WITH a plan of complete liquidation adopted after June 22, 1954, a corporation sold its assets, including accounts receivable at face value, in a transaction on which no gain or loss is recognized to the corporation under Section 337 of the Internal Revenue Code of 1954. However, there remained, on the books of the corporation, a reserve for bad debts which had at all times been reasonable and necessary and which had been accumulated by additions for which the taxpayer derived full tax benefits in prior taxable years. Held, the reserve for bad debts constitutes ordinary income to the corporation in its final Federal income tax return, since the need for maintaining the reserve ceased when the taxpayer disposed of the accounts receivable. See *Geyer, Cornell & Newell, Inc.,* 6 TC 96, *acq.* CB 1946-1, 2. [The *Geyer, Cornell & Newell* case held that a corporation must include in income the balance remaining in a reserve for bad debts in the year the need for the reserve ceased. —Ed.]. The fact that no gain or loss on the sale of the assets was recogniged to the corporation pursuant to Section 337 of the Code does not have any bearing upon the realization of income by the corporation when the need for maintaining the reserve for bad debts ceased.

competitor bank which had been availed of by the transferor bank as a tax deduction, such credit in the reserve would constitute taxable income to the transferor bank in the year its assets were acquired for the exchange of stock of the competitor bank.

In the event the acquiring bank had taken the ruling and the transferor bank failed to pay the tax arising under the Commissioner's theory of ruling, the acquiring bank would under transferee proceedings under Section 6901 of the Code be subject to said tax, as it had taken the assets of the transferor bank in exchange for its stock and was on notice of the proposed income adjustment.

What has herein been said with respect to a Section 368(a)(1)(C) type of acquisition is likewise applicable if an acquisition occurs by route of Section 368(a)(1)(A), (B) and (D), provided the transferor bank has a credit balance in its reserve for bad debts which has been recognized as a tax deduction.

The Commissioner's theory expressed herein is not limited solely to banks, but applies equally well to any other company which finds itself similarly circumstanced as the taxpayer bank in the instant discussion. This new policy on the part of the Service nullifies to a considerable extent the taxfree provisions of the above-cited subsections of Section 368 of the 1954 Code. This action on the part of the Service raises a further question in the writer's mind, namely, will the Commissioner cease with just collaterally attacking the reserve for bad debts, or will he attack similar reserves? ☆

Good and bad ways to get cash out of a closely held company

by **RICHARD L. GREENE** *and* **FRANK W. HAMMETT**

The matter of getting cash out of a closely held company presents varied and intriguing questions. No doubt much of the mental gymnastics of the tax planner is devoted to devising ways of accomplishing this. So, also, much tax litigation has involved the area of tax treatment of the cash so taken out.

THE APPROACH may vary, but the problem is basically whether the cash so enthusiastically taken out of corporate funds will be treated as ordinary income or as capital gain. The goal in this game seems to be to secure capital gain treatment. In fact, if the cash is treated as ordinary income, that is almost considered a personal foul. The loser in this game of getting corporate cash ends up with the badge of disgrace plus a potentially terrible tax bill.

Our executive shareholder in the closely held company is willing to pay ordinary income tax on his salary and on his dividends (if any are declared) and perhaps on a few fringe benefits, but otherwise he insists that all other cash that he takes from the corporation must be taxed as capital gain. You as his tax adviser, are therefore stuck with the problem of getting the corporate cash into his hands in the form of capital gain.

How not to do it

Most of the ideas that the client will present to you are wrong or risky. No doubt a friend of a friend or some advertising circular have given him a "brainstorm," and he passes the capital gain tax gimmick on to you with the expectation of immediate action. You then have the delightful chore of telling him politely and convincingly why the idea is wrong. But this is only part of your job. The most important aspect is to furnish, if possible, an alternative plan which will work.

For this purpose, we have conjured up a check list. Naturally, the first part covers how not to do it. The second suggests some ways cash can be taken out of the closely held company as capital gain.

Cash withdrawals

It is surprising how many shareholders have tried the simple expedient of just withdrawing cash from the controlled corporation and treating it as an open account. Frequently they forget to pay it back or more often delay it as long as possible. There has been much litigation in this field and many unfavorable decisions holding the withdrawals are taxable as constructive dividends. Occasionally this disaster can strike not only in one year but in a series of taxable years when withdrawals were made. Withdrawals should be avoided like poison ivy, but if unavoidable, the loans from the corporation had better be documented with a promissory note bearing a commercial rate of interest with regular substantial payments of principal and interest being actually made.

Excessive compensation

Another wrong way to take cash out of the closely held corporation is by excessive compensation. This is frequently foolish not only because the executive loses most of the cash by way of income tax payments at a high bracket, but also the closely held corporation may lose part of the deduction on the ground it was unreasonable and to that extent constituted compensation in the guise of a dividend.

Repayment of thin debts

The third wrong method of getting cash out of your corporation is by having the company make repayments on debt which is so thin that the Service or the courts will hold it as capital and not debt. If construed as capital, the payment is therefore taxed as a dividend and that may be a fatal blow to your executive stockholder.

Boot incident to reorganization

A less common, but occasionally disastrous way of taking cash out of the corporate till, is in connection with a corporate reorganization or acquisition. Many taxpayers carry the illusion that everything received in a corporate reorganization exchange is nontaxable. Too often, they have painfully discovered the cash received in the transaction with the exchange for stock is considered as "boot" and taxed as a dividend under Section 356.[1]

"Tainted" preferred stock

A once-popular method of taking cash from the closely held corporation was to issue a preferred stock dividend and at some later date have the corporation redeem part or all of it for cash. This has now become a risky business, for Section 306 of the 1954 Code treats preferred stock received as a dividend or in a nontaxable recapitalization, as "tainted" stock. This means that usually

either the redemption of the stock or the sale of the stock will result in ordinary income. There are exceptional cases under Section 306, but normally we avoid that type of stock unless the exceptions are clearly applicable.

Liquidation & reincorporation

Suppose your client suggests that the way to get the cash out as capital gain is to liquidate the corporation, throw the operating assets (machinery, inventory, etc.) into a new corporation and then continue the business as before. This simple little device has been tried, and very unsuccessfully, under the 1939 Code in the *Lewis* and *Survaunt* cases.[2] It is quite clear that the transaction would be treated *not* as a capital gain liquidation, but instead as a reorganization under Section 368 and the cash treated as "boot" and as a dividend under Section 356.

Redemption dividends

The corporate cash-capital gain idea that occurs to most clients involves a redemption of part of their stock. Sometimes this will produce capital gain. Often it will not, but instead brings on the pain of a taxable dividend. The results depend on careful compliance with the ground rules of Section 302 in light of the constructive ownership rules of Section 318. This we will discuss a bit later under the list of ways of getting cash out as capital gain.

When to take the cash?

Before solving the problem and considering the approved methods, you better have your client decide when the cash is to come out. The techniques and statutory tests may differ, depending on whether he needs the cash now, or upon retirement or after his death. These are covered in the check list.

Cash under Section 303

Suppose your client does not need the corporate cash now, but in the event of his death, his executors will need some cash to pay death taxes and expenses of administration. Prior to 1951, corporate cash paid out in partial redemption of the deceased stockholders stock was treated as a dividend. Now, however, it is given capital gain treatment under Section 303 of the Code, if the stock is a substantial asset of the estate, and satisfies certain mathematical tests, and if the cash does not exceed the total of the death taxes and administration expenses.

You should also note that *if* the amount paid by the corporation does not exceed the value of the stock on the date of death, the cash payment will in effect be tax-free. The reason for this pleasing result is that the stock received a stepped-up basis of fair market value at date of death, which is presumably the same amount as the redemption price. Here then is the free way of taking cash out of the closely held company *after* the stockholder's death for the vital purpose of paying his death taxes and probate expenses.

Section 531 pitfall

There is a pitfall in Section 303 redemptions that is usually overlooked. If the closely held company has been slack in dividend pay-out and is already a suspect for the Section 102 penalty (now Section 531 et seq.), a Section 303 redemption to pay death taxes might be the pressure to release the trigger sending this tax missile to the corporate heart. The earlier decision of *Koma*[3] so held and the recent *Pelton Steel Casting Co.* case[4] supports that view. Thus, the dividend policy and history should be examined and risks weighed before making a Section 303 redemption.

Tax-free cash to widow

Another fine technique for taking tax-free cash out of the corporation after the stockholder-executive's death is the voluntary payment to his widow. This is usually an amount equal to one year's salary of the deceased executive, and is generally deductible to the corporation.[5] Under most decisions involving the 1939 Code it is a tax-free gratuity to the widow.[6] The Service is not happy about this rule and no doubt will continue to litigate it with respect to payments in excess of the $5,000 exemption.

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Death benefits to widow

In addition to the voluntary payments to the widow, there are, of course, contractual ways of paying cash out to the widow. One is a deferred compensation or other employment contract that provides for death benefits to the widow. These, of course, are taxable as ordinary income but at presumably a lower bracket. The other method involves the use of the split-dollar type of insurance. The cash surrender value goes to the company and the excess death benefits pass tax-free to the widow or other beneficiaries. Actually, it is the insurance company that is making this payment and technically the cash is not coming from the closely held company. We mention it, however, because of its close affinity to and variation of the problem of getting cash to the widow.

Capital gain on retirement

The modern executive who plans well and carefully is concerned not only about cash payments to his widow, but also, to provide cash for retirement. There are basic methods of accomplishing this: deferred compensation and qualified profit-sharing or pension plans. These are discussed elsewhere. Suffice to note that the former produces ordinary income but at a lower bracket and the latter gives a cash payout at capital gain rates, if taken within one year. Usually not one but both methods should be adopted, if possible.

Cash by liquidation

Frequently the client's need for the corporate cash—all or part—is more immediate. He urgently desires it now and of course on a capital gain basis. Otherwise, if cash is to be removed as ordinary income, it becomes costly and unappetizing.

One of the most drastic methods of accomplishing this is a complete liquidation of the corporation plus a continuation of the business in the form of a family partnership or as a sole pro-

[1] 26 C.F.R. §1.356 (1957).
[2] Survaunt v. Commissioner, 162 F.2d (8th Cir. 1947); Lewis, et al. v. Commissioner, 176 F.2d (1st Cir. 1949).
[3] Jones v. KOMA Inc., 218 F.2d 530 (10th Cir. 1955).
[4] Pelton Steel Casting Co., 28 TC 153 (1957), aff'd — F.2d —, 58-1 USTC ¶9179 (7th Cir. 1958).
[5] American Factors, Ltd. v. Kanne, 76 F.Supp. 133 (D.C. Hawaii 1947); Rev. Rul. 212, 1955-1 CUM. BULL. 299.
[6] Simpson v. U. S., — F.Supp. —, 57-2 USTC ¶10,057 (D.C. S.D. Ill. 1957); Nixon v. U. S., — F. Supp. —, 57-2 USTC ¶9982 (D.C. E.D. Tenn. 1957); Rodner v. U. S., 149 F.Supp. 233 (D.C. S.D. N.Y. 1957).
[7] "Tax Traps and Danger Signals in the Life of a Small Corporation," 7 JTAX 130 (1957); "New Rulings Favor Taxpayers: Preferred Stock Redemptions, Spinoffs Permitted," 6 JTAX 10.
[8] Rev. Rul. 566, 1956-2 CUM. BULL. 888.
[9] Rev. Rul. 584, 1956-2 CUM. BULL. 179.
[10] Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954).
[11] Rev. Rul. 745, 1955-2 CUM. BULL. 223; Rev. Rul. 458, 1954-2 CUM. BULL. 167.
[12] Joseph R. Holsey, 28 TC — No. 107 (1957).
[13] Rev. Rul. 521, 1956-2 CUM. BULL. 174.
[14] Rev. Rul. 485, 1956-2 CUM. BULL. 176.

prietorship. Obviously this is a drastic form of surgery that is not often warranted because of various potential tax disadvantages, the most notable of which is that the tax bracket of the partners or sole proprietor after the corporate dissolution may be higher than the 30% or 52% corporate bracket.

There are cases, however, where this technique will fit perfectly and enable the stockholders to withdraw the cash as capital gain on liquidation and then continue the business. Moreover, it may be desirable at a later date to put the business back into corporate form. This can be done in light of the warning previously given, *if* the reincorporation was not planned or contemplated at the time of original liquidation.

Cash by sale to company

Another method of taking cash from the closely held company which is not often used is by sale of property to the corporation. For instance, the executive stockholder might sell his personal life insurance to the corporation. If this sale is made at the correct price, which is usually the interpolated terminal reserve (slightly more than cash surrender value), there would normally be no gain or loss on the transaction. He takes the cash and thereafter the corporation pays the premium on what becomes key-man corporate insurance.

The significant tax wrinkle in selling property to a controlled corporation is that if the sale price is more or less than the basis, the stockholder might have his loss disallowed under Section 267 (a) (1) or he might have his gain treated as ordinary income under Section 1239. These statutes should be carefully studied. Thus, it is usually preferable to sell only property whose value and sale price are substantially identical to the stockholder's cost basis.

One of the more popular ways of getting cash out of the corporation is by a redemption of stock. If done properly and carefully, and after a thorough analysis of the statutory ground rules set forth in Section 302 and 318, capital gain can be the desired result. Contrariwise, if the stockholder fails to comply with the statutory rules, he may end up with a horrendous dividend tax.

The whole field of redemptions is complex and involved and rampant with restrictive interpretations from the Service. It would not be feasible to go into these here.

We would prefer to refer to our editorials and various papers that have appeared in the JOURNAL OF TAXATION.[7] One point only will be stressed here: a disproportionate redemption i.e., more than 20% reduction) of the common stock is normally the easiest way to secure capital gain under Section 302, but this 20% or more reduction can be accomplished only after the constructively owned stock of family members listed in Section 318 is tacked onto the stock of the redeeming shareholder. In the typical family corporation, where stock of parents, children and spouses are tacked onto the stock of the redeeming shareholder, this is often a difficult feat.

There are two very helpful recent rulings approving capital gain treatment to stock redemptions. These are: *Rev. Rul.* 56-556[8] and *Rev. Rul.* 56-584,[9] both of which deserve careful study if a redemption is contemplated.

Combined sale-redemption

A frequent variation of the straight redemption is the combined sale and redemption. This provides a double source of cash—part from a sale of stock to another shareholder or outsider and the balance by a redemption of the rest of the stock by the corporation. This is sometimes called a "shoestring" purchase. If handled correctly, the redeeming shareholder will secure capital gain treatment under the *Zenz*[10] case and recent rulings,[11] and the purchasing or continuing shareholder probably would have no difficulty. Recently, however, a continuing shareholder, in *Joseph R. Holsey*,[12] ran into trouble because he had an option to purchase the stock of the other shareholder, and he assigned it to the corporation which redeemed the other shareholder's stock. This question was explored in 7 JTAX 269.

Redemption of preferred

We mention preferred stock redemptions as another means of getting cash out of the corporation. In the same breath however, we must underscore a firm warning that if the preferred stock was issued after 1954, a redemption is subject not only to the stringent rules of Section 302 but also Section 306. In many cases you will find a preferred stock redemption cannot safely produce capital gain.

There are, however, a few situations where it will fit nicely. Where the preferred stockholder owns no common stock, a complete redemption of his preferred may be successful—absent the constructive ownership of other stocks by a parent, child or spouse, etc., who continues on as a shareholder. See recent *Rev. Rul.*, 56-521.[13] So also a business purpose for the redemption may make it possible to comply successfully with Section 302 (b) (1), as in *Rev. Rul.* 56-486.[14]

We have touched gently on some of the major good and bad ways to get cash out of the closely held company. No doubt the needs of the eager client will suggest others. Each method, new or old, should be carefully screened in light of the tax restrictions on close corporations and the Commissioner's rapacious desire to construe cash taken out as ordinary income. ☆

Fundamental changes in corporate liquidation rules proposed by practitioners

ONE OF THE fundamentals in long-range tax planning has been the stockholders' gain on liquidation. Sometimes this rule has worked harshly for the taxpayer where there was no real change in the business on liquidation; sometimes it has given him only capital gain tax on what is essentially an income distribution. Changes, mainly to prevent the capital gains bailout, have added much complexity to the Code. Now here is a proposal for another change—to provide a carryover of basis and no tax on many corporate liquidations—made by the Advisory Group on Subchapter C appointed by the (Mills) Subcommittee on Internal Revenue Taxation (members of the group are listed in the adjoining box).

That this particular proposal may have tough sledding is indicated by the first reaction of the Federal Tax Committee of the Chicago Bar Association. The committee reveals a strong conflict of ideas, which sheds quite a lot of light on how the present law works in practice. This is what they told the Ways and Means Committee last month:

Bar group cautions against change

"Subchapter C is an extremely important and sensitive area of tax law,"

the committee on Federal Taxation of the Chicago Bar Association said, "and the suggestion of the Advisory Group are numerous and far-reaching . . . We have had a special subcommittee working steadily to study the recommendations and present its findings to our entire committee. But despite the best of intentions and almost daily meetings, we have been unable to complete more than a fraction of the work which the report demands. Under these circumstances, we normally would refrain from offering comment. However, we believe that certain general reactions of our group, which crystallized during our discussions, might be of sufficient interest in your review of the work of the Advisory Group that we should communicate them now . . . In this vein we wish to call attention to the following:

"Our experience with reviewing the advisory report suggests that the Bar requires considerably more time to think about the proposals. Many of them would affect a wide range of corporate transactions which have numerous and varying tax aspects. It is therefore difficult to trace through the consequences of the proposals and form sound judgments as to their merits.

"Even after the suggestions have been weighed on their merits, we urge caution in enacting a multitude of changes in the Subchapter C area. The Bar had to undergo a major re-educational effort as a result of the 1954 Code, which enacted some major modifications in the technical law. Unless there is strong need to overhaul particular provisions, it would seem unwise to make necessary another broad re-educational effort so soon. In saying this, we are aware that some "hardships" and some "loopholes" have been uncovered. But we believe that unless the hardships are shown to be seriously oppressive, or the loopholes are shown to be widely exploited or a significant drain on the revenues, it is generally better to live with the existing system rather than rush to undertake basic alterations . . . .

"Some of the proposals involve introducing into the corporate area concepts new to it. For example, one proposal calls for changing the long-standing rule that generally on liquidation of a corporation, gain or loss to the shareholder is recognized and the assets received in the liquidation then have a market value basis in the hands of shareholders. In its place, the revision would substitute a rule under which gain is to be postponed and the corporate basis for the assets is to be carried over to the shareholders. A similar arrangement is the existing Subchapter K covering partners and partnerships. Considerable dissatisfaction has developed with its operation, and we are far from sure it will prove workable even in the partnership field. The Advisory Group nevertheless recommends that it be imported into the corporate area, which is far more extensive and embraces more complicated liquidation situations."

Defects of present law

However, the Mills Group's analysis of current law cites its substantial defects, and it can cite changes proposed in the past by the Ways and Means Committee itself (the House version of the 1954 Code) and studies of the American Law Institute as supporting its finding that change is needed.

"Section 331 of the present law," the Advisory Group begins, "treats a partial or complete liquidation of a corporation as representing a sale by the shareholder of his interest in the corporation. Speaking generally, the shareholder realizes capital gain or loss in the amount of the difference between his basis for his stock and the fair market value of the property he receives in the liquidation. This rule creates two significant difficulties.

"While the transfer of assets by individuals in exchange for the stock of a new corporation upon its organization is not treated as a taxable transaction (Section 351), a transfer of the assets from the corporation to the individual shareholders upon liquidation of the corporation is treated as a sale by the shareholders of their stock in the corporation. Gain or loss to the shareholders is recognized even though no beneficial interest in the assets has passed from them to third parties. Thus if A owns real estate which cost $10,000 and is worth $25,000, he may transfer the property to a newly organized corporation in exchange for its stock without tax; but if thereafter he dissolves the corporation and receives back the same property in complete liquidation of the corporation, he is subjected to tax on $15,000 of gain.

One-month liquidation little used

"The harshness of the rule subjecting a stockholder to capital gains tax on appreciation in corporate assets when he merely dissolves a corporation without selling the assets to third parties has been alleviated from time to time in a provision now contained in Section 333. This section, in general, permits nonrecognition of gain or loss to the shareholder if the corporation is completely liquidated within a period of one calendar month, but subject to two important exceptions: (1) Gain is recognized to the extent of any cash and to the extent of any stock or securities acquired by the corporation after 1953, and (2) to the extent of any accumulated earnings or profits of the corporation gain is recognized and taxed to the shareholder as a dividend. Section 333 is not mandatory in its operation, but may be invoked at the election of 80% of the shareholders. Because of the drastic effect of taxing the accumulated earnings as a dividend at surtax rates to the shareholders at the time of the liquidation, and because of the other complexities of the present provision, it has been used by shareholders only to a very limited extent. The advisory group understands that in the entire history of this provision only some 1,500 corporations have elected to be governed by its rules.

The collapsible problem

"The general treatment of a corporate liquidation as the equivalent of a sale by the shareholder of his stock permits individual shareholders to make use of a corporation in order to convert into capital gain (with a maximum tax of 25%) profits which would be ordinary income to them (taxable up to 91%) in the absence of a corporation. For example, assume that an individual pays $10,000 into a new wholly owned corporation for all its stock. The corporation purchases for $10,000 inventory which soon appreciates in value to $25,000. The individual may, if there is no special statutory barrier, dissolve the corporation, pay a capital gains tax on $15,000 and sell the inventory without any profit being subjected to tax as ordinary income either in the hands of the corporation or in the hands of the individual.

"In an effort to prevent such abuses, the 1954 Code contains a provision in Section 341 relating to so-called collapsible corporations. Originally enacted in 1950 primarily to deal with certain temporary motion picture corporations and real estate construction corporations, it was extended in 1951 to cover

Advisory Group

MEMBERSHIP of the Advisory Group appointed by the Mills Subcommittee consists of the following well-known tax practitioners:

Norris Darrell, Chairman
C. Rudolf Peterson, Vice Chairman
Edwin S. Cohen
Marvin K. Collie
Kenneth W. Gemmill
Samuel J. Lanahan
Leonard L. Silverstein

corporations owning appreciated inventories and in 1954 to corporations having a broad category of so-called unrealized receivables and numerous items of real property and depreciable property used in trade or business.

"In existing law a collapsible corporation is one formed or availed of principally for the manufacture, construction or production of property, or the purchase of certain property, with a view to the sale or exchange of the stock by the shareholders before the corporation realizes a substantial part of the taxable income to be derived from the property. There is a possibility that Section 341 today may not only be a shield to protect the revenue against conversion of ordinary income into capital gain, but that it may also be an offensive weapon to convert into ordinary income items which would clearly be capital gain if the shareholders had not made use of a corporation. It has the further defect of depending for its application upon the intention of the shareholders of the corporation, and is difficult of application on a consistent and nondiscriminatory basis.

The House's 1954 plan

"In the internal revenue bill of 1954 (H. R. 8300) in the form in which it passed the House of Representatives, the Code would have been amended to adopt a different approach to the matter of corporate liquidations and collapsibles. The basic principle of the House bill in 1954 was to treat a corporate liquidation as a transaction on which gain would not be recognized to a shareholder except to the extent that the basis to the corporation for its assets distributed in the liquidation exceeds the basis to the shareholders of their stock in the corporation. With respect to a shareholder who had held his stock throughout the corporate existence, the excess of corporate asset basis over his stock basis will, in general, represent the accumulated earnings and profits of the corporation. This will also be true, in general, with respect to a shareholder who has purchased his stock from another stockholder, if there is taken into account the capital gain or loss realized by the predecessor holders of the stock on the sales made by them. Thus, under this system, income derived by the corporation would bear a corporate income tax and if not distributed out as a dividend would bear, in addition, a capital gains tax to the shareholders upon the sale of the stock or liquidation of the corporation, except to the extent such income is offset by any depreciation in value of the corporate assets. Unrealized appreciation in the corporate assets would not be taken into account in determining the liquidation gain of the shareholders.

"This approach of the 1954 bill as it passed the House of Representatives was not adopted in the final version of the 1954 Code. Instead, the final Code returned to the prior law with a number of modifications in the area of 'collapsible corporations.' After considerable deliberation, the advisory group has concluded that the approach of the House bill in 1954 is fundamentally sound and should be adopted, but with a number of important changes which, it believes, remove the principal objections made to the House bill at that time.

Mills Group proposal

". . . In the proposed revision, Section 331(a) would continue the rules of existing law that amounts distributed in complete liquidation of the corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation shall be treated as in part or full payment in exchange for the stock. Thus the amount of gain or loss realized in the transaction would continue to be computed, as in existing law, by the difference between (1) the value of the assets received and (2) the basis to the shareholder of the stock plus the corporate liabilities assumed by the shareholder and liabilities to which the distributed property is subject.

"However, in the proposed revision there would be inserted a new section . . . dealing with the extent to which the realized gain will be recognized to the shareholder . . . . [It] provides, in general, that if the adjusted basis to the corporation for the assets distributed in liquidation . . . exceeds the sum of the basis to the shareholder for his stock plus the corporate liabilities assumed by him in the liquidation and the liabilities to which the property is subject, then gain will be recognized only to the extent of such excess. . . . If there is no such excess no gain will be recognized on the liquidation. . . .

"The following examples illustrate the operation of these rules:

"1. Assume the shareholder has a basis for his stock of $10,000 and the property distributed in complete liquidation has a value of $30,000. The adjusted basis to the corporation for the distributed property is $25,000. The gain realized on the liquidation is $20,000 (value of $30,000 minus stock basis of $10,000), but the amount of gain recognized to the shareholder will be only $15,000 (corporate asset basis of $25,000 minus stock basis of $10,000).

"2. Assume the same facts as to stock basis and value of assets distributed, but assume that the basis to the corporation of the assets distributed is $9,000. Again the amount realized is $20,000 (value of $30,000 less stock basis of $10,000), but no gain will be recognized to the shareholder because the corporate asset basis ($9,000) is not in excess of the stock basis ($10,000).

3. Assume again that the stock basis is $10,000, but that the value of the assets distributed is only $7,000. There is, therefore, a loss of $3,000 realized on the liquidation ($10,000 stock basis minus $7,000 value of assets distributed). In that event, regardless of the basis to the corporation for the assets distributed, the entire realized loss of $3,000 would be recognized to the shareholder. In such event it would be immaterial whether the corporate asset basis was greater than, or less than, the stock basis.

"These rules would apply also where property is distributed in redemption of stock under Section 302(a).

"Under . . . the proposed revision gain would be recognized in the case of certain distributions in liquidation or in redemption of stock of collapsible corporations. Such distributions would be dealt with in a new Section 343 designed to forestall any significant conversion of ordinary income into capital gains tax by the device of liquidating a corporation, selling its stock, or selling

the corporate assets without corporate tax under Section 337. The present provisions of Section 341 dealing with collapsible corporations would be repealed. Also, the present provisions of Section 333 dealing with liquidations within one calendar month would be repealed.

"The American Law Institute, in whose studies the outlines of this approach were orginally developed, suggested that, except in the case of collapsible corporations, the limitation on the recognition of gain in corporate liquidations be made elective with each shareholder. The advisory group recommends, however, that the system described herein not be made elective but be made applicable in all cases. The advisory group believes that an elective system would create unnecessary administrative complexities and would interfere with the uniform application of the Internal Revenue Code.

"The American Law Institute had also suggested that the limitation on recognition of gain be made inapplicable in the case of certain publicly held corporations. The advisory group believes that a distinction between publicly held and closely held is not necessary and recommends that the rule have uniform application.

"The American Law Institute studies proposed that the recognition of gain to the shareholder be measured by reference to his ratable share of the entire basis to the corporation of all its assets distributed in the liquidation instead of by reference to the basis of the particular assets distributed to the taxpayer. While the use of the shareholder's ratable share of the entire corporate asset basis would be feasible, the advisory group concluded on balance that the operation of the system would be simplified if the shareholder were required to compute his recognized gain by reference to the basis of the particular assets distributed to him. While this might produce different results for different shareholders if each does not receive his ratable share of the corporate asset basis in the distribution, it is believed that this is a matter which can be satisfactorily adjusted by the shareholders between themselves in working out the plan of liquidation. Comparable problems of basis have existed for many years in the area of distributions in kind by partnerships, estates, and trusts and have caused no particular difficulty. No serious opportunities for tax avoidance would exist, for if any substantial amount of noncapital assets are distributed in the liquidation and each shareholder does not receive his ratable share of the noncapital assets, the special rules of Section 343 will be applicable to protect the revenue." ☆

New corporate decisions this month

Stockholder-creditor had business bad debt; was in business of lending. From 1937 on taxpayer advanced money on the security of its plant to a meat-processing corporation of which he was a stockholder. In 1942 he became the majority stockholder. In 1949 taxpayer foreclosed on these properties but allowed the company to continue to use them. The fair market value of the foreclosed property and the remaining assets of the corporation were $90,000 below the remaining debts of the corporation to taxpayer. The court allows taxpayer to deduct the $90,000 as a bad debt in 1949. The intent of the parties is controlling and here the parties clearly indicated their intention to treat the advances as a loan by providing security. The foreclosure was the identifiable event which fixed the loss. The loss is a business bad debt, not a non-business bad debt, because taxpayer was in the business of lending money. The court notes that almost daily taxpayer interviewed prospective borrowers, that he made many loans, kept records of them, was diligent in enforcing collection and became the dominant factor in many enterprises as he did in this meat packing company. *Yeager,* DC Ky., 12/2/57.

Stockholder's advances a nonbusiness bad debt. A taxpayer who had advanced over $18,000 to a restaurant corporation in which he was a stockholder-officer is denied a business bad debt deduction upon the debt becoming worthless on the ground that the debt was not proximately related to any business in which he was engaged. Although taxpayer had been an owner of hotels and hotel restaurants for many years, he never had dealt in hotel properties as a business. *Leshnick,* TCM 1958-1.

Dividend-paid credit allowed though stock was issued after 1942. A public utility may take credit for dividends paid on certain of its preferred stock if the stock was issued before 1942 or if it replaced stock originally issued before that date. In 1948 taxpayer's parent was dissolved under the "death sentence" provisions of the Public Utility holding Company Act. At that time taxpayer issued preferred stock to replace its parent's preferred stock issue. The court holds this stock meets the requirements of the statute as to a refinancing after 1942 and allows taxpayer credit for the dividends paid. *Public Service Electric and Gas,* Ct. Clms., 1/15/58.

"Bonds" really preferred stock; "interest" disallowed. A family trust which had been held to be an association taxable as a corporation in a prior proceeding paid "interest" on instruments purporting to be bonds. After analyzing these instruments, the court finds that they are in legal effect preferred stock representing a capital investment and accordingly disallows the interest deduction. The payment of interest was contingent upon the net income being sufficient, interest was not cumulative, the principal was payable to a specific settlor if living at the termination of the trust (which coincided with the maturity date of the "bond"), and upon expiration of the trust, the holders of the "bonds" were entitled to share in all the assets of the trust ratably. *Hoersting Family Trust,* TCM 1958-3.

Dividend in sale of "brother" stock to another controlled corporation. A sale by a stockholder of his stock in a wholly owned personal service corporation to a second corporation of which he was the sole beneficial owner, for a price of $225,000, is determined to be an arrangement for the distribution of earnings and profits and is held taxable as a dividend. The court notes that the corporation whose stock was sold had liabilities in excess of assets at the time of sale, while the purchasing corporation, a new corporation, had no tangible assets and the only source from which it could pay the price was future earnings. *Gold,* TCM 1958-2.

Diverted corporate funds taxable to stockholders only as dividends. The court approved the Commissioner's action in increasing corporate income by unreported gain from over-ceiling sales of meat to the extent of about $200,000 over a three-year period. The four corpo-

rate stockholders having diverted the unreported sales for their own use, as shown by their net worth increases, were held by the Tax Court to have understated their income. On appeal by the stockholders, this court remands the case to the Tax Court to determine whether the corporation had accumulated earnings equal to the diverted funds at the time of diversion. The funds can be taxed to the stockholders only as dividends. Although the question of accumulated earnings was not raised until Rule 50 computations were prepared, justice requires that the Tax Court consider it—substantial amounts of tax depend on the outcome. *Simon*, CA-8, 10/29/57.

Groman rule applicable to "alter ego" subsidiary (Old Law). In *Groman* (302 U.S. 82) the Supreme Court denied tax-free status to the acquisition by Glidden Corp. of the assets of an Indiana corporation. The assets went to a newly formed subsidiary of Glidden, and the Indiana stockholders got cash, Glidden stock and stock of the new Glidden subsidiary. The Court reasoned that the Glidden subsidiary was not wholly owned by Glidden; therefore, there was not sufficient continuity of interest. In the case here at issue, the transaction was the acquisition by Allied Stores of the assets of Davis. After the deal was arranged, Allied requested transfer of Davis assets direct to a wholly owned operating subsidiary. Each of Allied's chain of stores was a separate corporation. The court below held the exchange tax-free, because the subsidiary here was wholly owned and a mere alter ego of Allied. This court reverses, holding the *Groman* rule applicable to the case of a wholly owned subsidiary. [Section 368 of the 1954 Code specifically includes as tax-free the acquisition of assets for stock of the acquiror's 80%-or-more parent.—*Ed.*] *Jones*, CA-6, 1/2/58.

Planned stock redemption doesn't forestall 531 (old 102) tax. The Commissioner asserted tax under Section 102 (Section 531 of 1954 Code) for 1946 and taxpayer defended on several grounds: (1) general economic conditions, (2) a plan had been adopted (it was carried out in 1947) whereby the company borrowed heavily and used most of its available funds to buy 80% of its stock—held by two stockholders who had been trying to sell their interests and (3) need for plant expansion. The Tax Court found that by 1946, since taxpayer was "out of the woods financially" by the end of 1945, it could have paid dividends. That court while conceding that protection of the corporation from sale to outsiders and reduction to the state of "captive foundry" is a corporate purpose, noted that the same result could have been achieved by declaration of a dividend of 1946 earnings and redemption for a lower price. The need for plant expansion was dismissed as inconsistent with the stock buyout. The Tax Court concluded the question of whether or not the earnings or profit were permitted to accumulate beyond the reasonable needs of the business was not essential to the decision of this case because taxpayer failed to sustain his burden of proving the absence of the interdicted purpose: the avoidance of payment of surtax by the shareholders. The Tax Court said that the very substantial and obviously anticipated tax savings to the controlling shareholder in the redemption made it impossible to accept the view that saving surtax did not to some degree permeate the plan. The existence of obvious alternates for achieving the retirement of some charges contradicts the sole reason for the failure to distribute earnings. This court affirms. It is satisfied the taxpayer was availed of to avoid surtax. *Pelton Steel Casting Co.*, CA-7, 1/7/58.

Gains from commodity futures are PHC income, but gains and losses are to be netted. Taxpayer-corporations engaged in a wide variety of commodity-futures transactions, the gains from which were personal holding company income. In applying the gross income test for a personal holding company under the 1939 Code, the Tax Court held that gains are includible without reductions for any losses on such transactions. The 1954 Code provision permitting a netting of capital gains and losses was not to be applied retroactively. This court reverses. It believes the intent of Congress under the 1939 Code was not to classify a corporation such as this as a personal holding company when its net gains from commodity trading were small. *Sicanoff Vegetable Oil Corp.*, CA-7, 1/29/58.

Loss allowed on tax sale though family firm was buyer. A tract of land owned by taxpayer was seized in 1940 by the county for nonpayment of taxes and was sold by the county tax authorities in 1946, after taxpayer's right of redemption in the property was terminated, to a corporation wholly owned by taxpayer and his family. The Tax Court held taxpayer was not entitled to a loss deduction on two grounds. First, he had never abandoned the property; second, the seizure and sale was an indirect sale between related taxpayers. This court reverses. The seizure and subsequent purchase by the corporation were distinct events. The sale to a related taxpayer was made by the tax authorities, not by taxpayer, so the nonrecognition-of-loss provision does not apply. *McNeill*, CA-4, 1/11/58.

Sale of stock of one related company to another not a dividend. Proceeds received by a taxpayer on the sale of stock of one wholly owned corporation to another wholly owned corporation at book value is not a taxable dividend to him. The court follows its decision in *Pope* (TCM 1956-41, *aff'd* 239 F.2d 881), that such a sale is not a dividend insofar as the price is fair. In this situation, the court continues, in the absence of any different showing, the book value of stock is sufficient evidence of its actual value. [Under the 1954 Code, the purchase would be treated as a redemption of the stock of the acquiring corporation.—*Ed.*] *Westerhaus Co.*, TCM 1957-213.

Subsidiary formed to take over part of parent's business; no $25,000 surtax exemption. A corporation which owned and operated four theatres and the concession stands in them formed a new corporation, acquired all of the latter's stock and leased to it the concession stands for a stated rental. The court finds that the major purpose of the formation of taxpayer, the execution of the lease agreement, and the "transfer" of a leasehold interest in the concession property was to effect tax savings. Accordingly it denies to taxpayer pursuant to Section 15(c) of the 1939 Code the benefits of the $25,000 exemption from surtax. However, taxpayer is held to qualify as a "new corporation" under Section 430(e)(1)(A) for purposes of computing its excess profits tax credit. The fact that taxpayer purchased the merchandise and supplies at a sum equal to the parent's cost did not mean that the basis of the assets was determined by reference to the transferor's basis. *Theatre Concessions, Inc.*, 29 TC No. 83.

TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Selling a partnership or its assets: some possibilities suggested by the Willett case

by J. BRUCE DONALDSON

When a corporation wants to sell appreciated property, the tax man now has a statute, a good many cases and cosiderable literature on the subject to aid him in devising the safest course at lowest possible cost to the stockholder. The problem of a partnership with appreciated assets, while raising somewhat the same questions, has been less litigated; the Code is less clear, and published comment sparse if not almost nonexistent. Mr. Donaldson calls to our attention a recent Tax court case in which the rationale of Court Holding was applied to a partnership, and discusses some possibilities in the 1954 Code for avoiding such troubles.

SALE BY A partnership of all its assets, followed by distribution of the proceeds in cash to the partners, produces different tax consequences from a sale by the partners of their partnership interests.

Sale of all the partnership assets has the following tax consequences:

1. Gain or loss is recognized upon each separate asset sold.

2. Character of the gain or loss is controlled by the nature of each asset in the partnership hands.

3. The distributive share of the gain or loss on each asset sold is determined by the partnership agreement or by the ratio in which profits and losses are shared.

4. The partnership taxable year does not necessarily close and the partnership does not automatically terminate at the date of sale.

5. Upon distribution of the cash proceeds in liquidation a second gain or loss is recognized to the individual partners.

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Sale by the partners of their respective partnership interests produces these results:

1. Each partner recognized separate gain or loss which depends upon comparison of the basis for his partnership interest with the sale price received.

2. The gain or loss recognized is capital in character, except the part of the proceeds attributable to the partnership's unrealized receivables or substantially appreciated inventory produces ordinary gain.

3. The partnership year closes and the partnership is automatically terminated at the sale date.

Comparison of these differing tax consequences indicates that, depending upon individual factual circumstances, it may be advantageous to cast a sales transaction in one category rather than the other.

For example, where the sale will produce gain and no unrealized receivables or substantially appreciated inventory exist, it will generally be advantageous to arrange the transaction as a sale of the partnership interests. If the partnership does own unrealized receivables or substantially appreciated inventory, the effect of Section 751 must be carefully assessed. If the tests of that section are met, then proceeds allocable to these assets produce ordinary gain. Special advantages are inherent in the situation where the partnership owns appreciated inventory which does not quite qualify within the substantial appreciation test (120%) contained in Section 751 (d); sale of the partnership interest converts this inventory appreciation into capital gain.

Contrastingly, where the partnership owns deflated assets which will produce ordinary loss upon sale, it may be preferable to cast the transaction as a sale by the partnership. Advantages also exist in this method where recognition of the loss is sought upon liquidation, or where it is disadvantageous, because of income bunching, to close the partnership taxable year at the date of sale.

From the purchaser's side the nature of the transaction can be important. Where the transaction takes the form of a sale of assets, allocation of the purchase price is possible among the various classes of assets. The purchaser has reasonable certainty that the amounts allocated to depreciable assets, for example, will be acceptable and can forecast his future deductions. The purchaser of partnership interests will not have the evidence of arm's length bargaining to support an allocation of his price to specific assets.

Other possibilities

Assume a partnership owning, as its principal asset, substantially appreciated inventory which it is presently propitious to sell. A corporation is formed, the inventory placed in the corporation, and the stock is issued to the partnership.

The abortive attempt in the *Willett* case (*Lambert Willett at al.*, TCM 1957-189) of a partnership to achieve capital gain by shifting appreciated inventory into a corporation and selling the corporation's stock is suggestive of several other possibilities.

The plan of avoidance in the *Willett* case attempted to achieve capital gain on the inventory disposition through sale of the corporation's stock. At least three alternatives exist to the *Willett* method:

1. Sale of the inventory by the newly formed corporation.

2. Sale of a part of the inventory by the corporation followed by a liquidation.

3. Sale by each partner of his interest

THE FACTS OF THE WILLETT CASE

A PARTNERSHIP, Willett Brokerage Company, was formed in 1944 by members of the Willett family. The partnership engaged in the wholesale whiskey business. Under the Emergency Price Control Act, the price of liquor was controlled from 1942 to late 1946. During the period of controls the partnership built up a large whiskey inventory.

Early in July, 1947, the partnership advised a broker that it owned a substantial inventory of whiskey; it was made clear, however, that any sale must take the form of a sale by the partners of their partnership interest. The broker immediately contacted a potential purchaser who expressed interest in the whiskey.

On July 30, 1947, the partners of Willett Brokerage caused incorporation of Wildwood Corporation. The bulk of the partnership's whiskey inventory, together with certain other assets and partnership liabilities, was transferred to the corporation in exchange for its stock. The corporation's stock was issued to the partners in the same ratio as their respective partners interests.

Between July 30th and August 15th the corporation sold two small bulk lots of whiskey.

Sometime in August, 1947, the broker was informed of the formation of Wildwood Corporation and its ownership of the whiskey inventory. On August 6th, the broker told the Willetts he had located a prospective purchaser for the stock and suggested that the parties meet in New York to negotiate the terms of sale. On August 19th negotiations commenced which culminated in the sale by the Willetts of all of their stock in Wildwood Corporation.

The court's decision

The issue presented to the Tax Court was whether, as the taxpayers contended, the gain realized upon the sale of the Wildwood stock was capital in character, or whether, as the Commissioner determined, the transaction represented in substance a sale of inventory by the partnership.

The court held (TCM 1957-189) upon the authority of *National Investors Corporation* v. *Hoey* (144 F.2d 466) and *Moline Properties, Inc.* v. *Commissioner* (319 U. S. 436), that Wildwood should not be recognized as a corporation for tax purposes. The conclusion was predicated upon a finding of fact that the corporation, served no business purpose, performed no business function, and was created solely as a conduit for the transfer of the whiskey.

The second step in the decision pushed the gain realized on the stock sale back into the partnership. The court, citing *Commissioner* v. *Court Holding Co.* (324 U. S. 331), held that the sale consisted, in substance, of a sale of whiskey by the partnership, Willett Brokerage Company. The court attributed the sale to Willett Brokerage on the basis that the partnership instituted the initial step in the series of steps which culminated in the sale.

in the partnership.

What tax consequences attend these three *Willett* alternatives?

The first plan seeks to shelter the unrealized inventory gain from the high brackets of the individual partners by substituting the corporation's lower rate. However, while the corporate rate may be lower than that of the partners, there will be a second tax upon corporate liquidation in order to pass the gain to the partners. This double tax would normally render this method impractical.

Sale of part of the inventory by the corporation followed by corporate liquidation might appear to achieve a desirable result. Corporate sales, substantial in amount, would appear to preclude disregarding the corporate entity under the *Moline Properties* principles. Corporate rates would apply to the gain on the portion of the inventory sold. Liquidation produces both capital tax and a stepped-up basis for the unsold inventory.

The risks, however, outweigh the benefits. A corporation so utilized would, in all likelihood, be a collapsible corporation within the ambit of Section 341. Combination of a corporate tax upon the inventory sold, plus "collapsible" treatment on the entire gain realized on liquidation, would be a severe penalty.

The third method seeks capital gain on the sale of the partnership interests. Section 741 provides that gain or loss on the sale of a partnership interest is capital in nature. Section 751 limits Section 741 and provides that the part of the proceeds of sale which are attributable to unrealized receivables or substantially appreciated inventory produce ordinary income. The third alternative attempts to convert substantially appreciated inventory into capital asset stock by transferring the inventory to a corporation. The stock is now a partnership asset instead of the inventory. Sale of the partnership interest, assuming the reclassification is successful, produces a gain which is entirely capital.

This reclassification, or recharacterization, possibility is the most interesting of the three alternatives suggested. However, it promises no more success than the other two. Since the corporation is without business purpose or function, it seems probable that under the *Moline Properties* type rationale it would be ignored for tax purposes.

On the whole, these methods of avoiding the restraints of Section 751 seem too hazardous. Perhaps the best line of approach is to consider shifts in the other assets of the partnership so that the arithmetical tests of Section 751 no longer fit. Note that Section 751 does not apply to inventory unless the fair market value of the inventory exceeds 120% of its adjusted basis and constitutes more than 10% of the fair market value of all partnership property other than money. Attention to purchasing policy might permit the recently purchased, unappreciated inventory to increase enough to make the appreciation a safely small percentage of the total. Or a change in credit policy might increase receivables enough to avoid 10% rule.

Recognition of the advantages of the alternative methods of sale is but the first step; even choice of the better method is not the end of the tack.

The importance of the *Lambert Willett* case is the display by the Tax Court of a willingness to apply the *Court Holding* rationale to the partnership. It will be necessary, therefore, to adhere to the ritualistic formalities born of the *Court Holding* and *Cumberland* (*United States* v. *Cumberland Public Service Co.*, 338 U. S. 451) decisions. It is necessary, for example, to conduct all negotiations in a manner designed to press the transaction into the desired form. All correspondence and docu-

ments should be prepared in language specially articulating the chosen method of sale. Unremitting attention must be given to working out the details of negotiations and sale so that there is no chance for the IRS to assert that the seller in form was not the seller in substance.

New partnership decisions this month

Jury finds no intent to make trusts partners. Taxpayers created seven trusts for their children, then formed a partnership including the trusts as partners. The jury found that there was no intent to form a partnership and held taxpayers chargable with all the income of the partnership. [Few facts are reported. Apparently the years at issue were prior to 1951. Since that date the Code specifically recognizes partnership interests though created by gift, if the profit distributions properly compensate services and capital.—*Ed.*] *Eisenberg,* DC Pa., 11/18/57.

Family partnership recognized to extent interests in profits not shifted. Taxpayers were brothers. They and their wives each owned 25% of the stock of a furniture distributing corporation. When they acquired a new line of higher priced furniture they organized a limited partnership to distribute it, rather than distribute through the existing corporation. The court recognizes the partnership as a valid tax entity, even though it was motivated by tax savings. However, one brother took only a 15% interest in the partnership profits, the remaining 10% to go to trusts for his children, which contributed neither capital nor services. Since the partnership income was derived largely from services, the income for the years 1941 to 1946, at issue here, is to be reallocated. [Since 1951, the Code specifically recognizes partnership interests though created by gift, if the profit distributions properly compensate services and capital.—*Ed.*] *Leeb,* DC Ill., 11/5/57.

State court proceeding determines partnership tax status. Taxpayer's alleged partner's rights were adjudicated in a state court and held to be only a creditor's interest. The Tax Court holds taxpayer cannot claim any of the partnership's operating loss. Taxpayer is also denied a bad debt deduction for amounts advanced to the business because of failure to prove worthlessness. *Shannon,* 29 TC No. 80.

Hotel partnership can't deduct meals and lodging for resident partners. Taxpayer, husband and wife, were partners in the business of operating a hotel and lived at the hotel as resident managers. The Tax Court originally had allowed the costs and expenses of furnishing their meals and lodging as a business expense. After reversal by the Eighth Circuit, the Tax Court disallows $1,200 of the partnership expense as personal. In making such determination, it gives no consideration to the money value of the economic benefits derived by the partners from their residence. *Moran,* TCM 1958-5.

New decisions on exempt institutions

Organization maintaining two-way radio system exempt. Section 501(c)(12) exempts from tax cooperative telephone companies if 85% of their income consists of collections from members to meet expenses. The IRS now rules that a non-profit organization maintaining a two-way radio system for its members on a mutual cost-sharing basis is exempt, provided it meets the 85% test. *Rev. Rul.* 57-420.

Foundation exempt despite mortgage retained by founder. The settlor of this charitable foundation gave it a building, subject to a mortgage payable to himself. The court found that the building was worth some $280,000 and was subject to an insurance company mortgage of $120,000 and the second mortgage retained by the founder of $50,000. It holds that the mortgage payments to the settlor did not cause the foundation to lose its exempt status. The court also finds that during the years in question the foundation did not unreasonably accumulate income. [The facts also indicate that the foundation was beneficiary of insurance on the founder's life and that it paid premiums on the policy. The finding of fact said merely that the premium payment did not destroy the exemption.—*Ed.*] *Tell Foundation,* DC Ariz., 11/26/57.

Organization to build stadium for school district is exempt. A corporation was organized to build a stadium for a school district with no profit to the stockholders. The IRS rules it is exempt as an organization operated exclusively for the promotion of social welfare. Contributions to it are deductible as contributions for the use of a political subdivision for exclusively public purposes. *Rev. Rul.* 57-493.

Exemption upheld for corporation buying and testing hospital supplies. Taxpayer was organized as a nonprofit corporation under the New York Membership Corporation Law. Its function was to test hospital supplies to ascertain that certain quality standards were maintained and to buy approved supplies for its member hospitals. Any income in the form of dues, cash discounts, service charges and jobbers' fees was returned to the members (some 270 hospitals) on a patronage basis. The court holds taxpayer was not organized to engage in business nor do its activities result in taxable unrelated business income. The court rejects an interpretation of the Regulations that would deny the exemption because more than one exempt institution was served. Nor was it a "feeder" under the 1950 law; it was not organized for profit. At most, taxpayer was merely performing a function for its members that they would otherwise have to do for themselves. *Hospital Bureau of Standards, Inc.,* Ct. Cls., 1/15/58.

Trust for student nurses is charitable [*Acquiescence*]. Decedent's will bequeathed a fund in trust for the payment of $100 or $150 to each of the student nurses in training at a certain hospital. Although the payments could be used by the nurses in any way, the trust was for the benefit of a general class. The court construes the provision for charitable deductions liberally and allows the deduction. *Davis Estate,* 26 TC 549, *acq.* IRB 1957-41.

No deduction to newspaper for publishing free advertisements for charities. The value of newspaper space donated by a newspaper to a charitable organization does not qualify as a charitable contribution since the newspaper is not donating property, but is merely rendering a service. *Rev. Rul.* 57-462.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Tax Court wrong in denying taxpayer the rule laid down in his circuit

by **F. TROWBRIDGE VOM BAUR** *and* **GEORGE M. COBURN**

We can expect to see soon an authoritative answer to the question of whether the Tax Court is required to follow the law as laid down by the Circuit Court of Appeals for the taxpayer's circuit or whether it can properly insist on its own position until the Supreme Court speaks. The Tax Court has taken the stand that as a nationwide tribunal it is not bound to follow the position of any particular circuit. The issue is now before the Supreme Court, which has granted certiorari in Sullivan. Messrs. vom Baur and Coburn analyze the status of the Tax Court and the legislation creating it and conclude that it is exceeding its powers in taking that position.

IN TWO RECENT decisions in which it reversed the Tax Court, the Court of Appeals for the Sixth Circuit used exceptionally strong language criticizing the lower court's failure to decide the cases in accord with previous holdings of the circuit. "In both these tax reviews," the court said, "the respective tax judges have refused to follow, as the settled rule of this circuit, our decision in *Owensboro Wagon Company* (209 F.2d 617 (CA-6)), reversing the decision of the Tax Court reported in 18 TC 1107." There was no doubt that "the factual situation involved in the *Owensboro Wagon Company* case is, for all practical purposes, identical with the facts encountered here."

"Hence," continued the Court of Appeals, "the situation developed in these cases requires the expression of our considered opinion that the Tax Court of the United States is not lawfully privileged to disregard and refuse to follow, as the settled law of the circuit, an opinion of the court of appeals for that circuit. If the Tax Court is not bound on questions of law by decisions of the appropriate circuit having jurisdiction, why should any jurisdiction be vested in circuit courts of appeals to review decisions of the Tax Court? The district courts of the several circuits also have statutory jurisdiction in tax cases and they are bound to follow the rules of decision pronounced by the United States Court of Appeals having appellate jurisdiction over the particular district court. The Tax Court is no less bound to do so. The mere fact that it is a court having jurisdiction in tax cases throughout the United States does not establish the Tax Court as superior in any aspect to United States district courts.

"The desire of the Tax Court to establish by its decisions a uniform rule does not empower it to disregard the decisions of its several reviewing courts of appeals. It is for the Supreme Court of the United States—and for that tribunal alone—to review and reverse decisions of the courts of appeals of the United States in their respective jurisdictions. Until the Supreme Court reverses a rule by a court of appeals for its circuit, that rule must be followed by the Tax Court."[1]

In a later case the Court of Appeals for the Seventh Circuit, in dealing with a similar situation, stated the problem in a nutshell: "Lacking such a decision by the highest court, a decision by one judge of the Tax Court, which, in effect, overrules a decision of the court of appeals in the circuit in which both cases arose, is not consonant with the responsibilities of the respective tribunals involved."[2]

The different view of the Tax Court was stated in the *Stacy Mfg. Co.* case by the single Tax Court judge sitting, as follows: "Accordingly, we have fully reconsidered the question in the light of, and with due regard for, the views expressed by the Court of Appeals in its opinion. After such study, we remain unconvinced of any error in our position. Thus, in all good faith, we must affirm the position heretofore taken by us, and with high respect for the honorable Court of Appeals, decline to follow."[3]

Again in the *Richmond Hosiery Mills* case, the single Tax Court judge said: "Not being convinced that our position was incorrectly taken, we respectfully declined to follow the contrary view of

[1] Stacey Mfg. Co. v. Commissioner and Richmond Hosiery Mills v. Commissioner, 237 F.2d 605, 606 (6th Cir. 1956).
[2] Sullivan v. Commissioner, 241 F.2d 46 (7th Cir. 1947), *cert. grant.*, 354 U.S. 920 (1957).
[3] Stacy Mfg. Co., 24 TC 703, 707 (1955).
[4] Richmond Hosiery Mills, Par. 55, 213 P-H Memo TC (1955). And in Houston Farms Development Co., 15 TC 321 (1950), the Tax Court said: "On the issue of apportionment in a memorandum opinion of this court we were reversed by the United States Court of Appeals for the Fifth Circuit, Driscoll v. Commissioner, 147 F2d. 493. We think the facts in the instant case are indistinguishable from the controlling facts in the *Driscoll* case, *supra*. Nevertheless, with due deference to the opinion of the circuit court in that case, we will adhere to our decision in this case." In reversing the Tax Court, the Court of Appeals disagreed "with the view that the Tax Court ought to, or could, in this case disregard" the appellate court's decision. Houston Farms Development Co. v. Commissioner, 194 F.2d 520 (1952).
[5] Best Lock Corporation, 29 TC No. 43 (11/29/57). The decision was reviewed by the full Tax Court. Interestingly enough, one judge dissented on the precedent issue, saying: ". . . I think the present case is not distinguishable on its facts from E. H. Sheldon & Co. v. Commissioner, 214 F.2d 655 (CA-6, 1954), reversing 19 TC 481; and that the decision of the Court of Appeals in said case should be followed here."
[5a] This question has been discussed recently in the following periodicals: Orkin, "The Finality of the Court of Appeals Decisions in the Tax Court: A Dichotomy of Opinion," 43 A.B.A.J. 945 (1957); Comment, "Heresy in the Hierarchy: Tax Court Rejection of Court of Appeals Precedents," 57 COL. L. REV. 717 (1957); Comment, "The Tax Court, the Courts of Appeals and Pyramiding Judicial Review," 9 STAN. L. REV. 827 (1957); Note, "Controversy Between the Tax Court and Courts of Appeals: Is the Tax Court Bound by the Precedent of Its Reviewing Court?", 7 DUKE L. J. 45 (1957); Case Note, 70 HARV. L. REV. 1313 (1957).
[6] Dobson v. Commissioner, 320 U.S. 480 (1943). See generally Paul, "Dobson v. Commissioner, The Strange Ways of Law and Fact," 57 *Harv.* L. REV. 753 (1944).
[7] 43 Stat. 253, 336.
[8] See S. Rep. No. 398, 68th Cong., 1st Sess. 8, 9, 42, (1924); H.R. Rep. No. 179, 68th Cong. 1st Sess. 7 (1924).
[9] John Kelley Co. v. Commissioner, 326 U.S. 521, 527-28 (1946).
[10] Revenue Act of 1924, §§274(b), 279(b), 308(b), 312(b), 900(g), 43 Stat. 297, 300, 308, 311, 337.
[11] Revenue Act of 1926, 44 Stat. 9.
[12] §1001(a) of the Revenue Act of 1926, 44 Stat. 109. The judicial character of the Board of Tax Appeals and the "appellate" character of review of its decisions by the courts of appeal, is shown by the following statement in the Committee Reports on the Revenue Act of 1926: "In the view of the committee the decisions of the board are judicial and not legislative or administrative determinations. . . . The imposition upon the court of the duty of reviewing judicial decisions, such as those of the board, is not the imposition

the United States Court of Appeals."[4]

Again in the recent *Best Lock Corporation* case, the Tax Court said: "We have carefully reexamined our position on this question in the light of the decision of the Court of Appeals in the *Sheldon* case, *supra*, and if that case is not distinguishable on the facts, we adhere to the views expressed in our decision in 19 TC 481, with all due deference to the Court of Appeals for the Sixth Circuit."[5]

Reading this language apart from its setting, one is naturally inclined to think of some court of last resort of an independent sovereign, uttering a polite and diplomatic expression of its own juridical independence and disagreement with the courts of another sovereign. Such a disagreement, however, within our Federal judicial machinery, is virtually unparalleled; and it clearly raises the question as to what place the Tax Court has in our judicial system. Stated more specifically, the question is whether the Tax Court is bound, as a matter of *law*, to follow the precedents of the court of appeals for a particular circuit in a case appealable to that court.[5a]

That question appears to remain with us as a troublesome consequence of the *Dobson* case[6] and the upheaval of confusion which it created with regard to the scope of review of Tax Court decisions. It would appear, however, with the Congressional repeal of the *Dobson* case, that, like the Federal district courts, the Tax Court is bound by decisions of a court of appeals in cases appealable to that circuit. That is the point we shall endeavor to make hereafter.

The history of the Tax Court is one of Congressional efforts to judicialize its functions and integrate it into the judicial structure. Under the Revenue Act of 1924,[7] Congress established the Board of Tax Appeals, the old name of the Tax Court, as an administrative tribunal to "secure an impartial and disinterested determination of the issues involved."[8] The taxpayer and the Government were to "have an independent review of the position of either on tax demands before payment of the tax or foreclosure of an asserted deficiency."[9] Findings of the board, however, were to be only "prima facie evidence of the facts therein stated," and judicial review of an adverse decision of the board was made available to either the taxpayer or the Commissioner by an action *de novo* in a Federal district court.[10] But in 1926 a radical change in the character of the board occurred. By the Revenue Act of that year,[11] its decisions became generally comparable to those of a Federal district court in that a "decision" of the board was intended to be made subject to an "appellate" review by one of the eleven courts of appeals.[12] The venue provisions were designed for the convenience of the taxpayer.[13] Upon such review the cognizable court of appeals was given power to modify or reverse the decision of the board if "not in accordance with law,"[14] and judgments of the courts of appeal were made "final,"[15] subject to review by the Supreme Court upon certiorari. The Committee Reports explicitly stated that the "procedure for review of determinations is made to conform as nearly as may be to the procedure in the case of an original action in a district court."[16]

But before we can consider the relationship between a court of appeals and a subordinate district court, we must consider two important Supreme Court decisions that helped to nurture the Tax Court's independence of the precedents of the reviewing court of appeals. While some early decisions of the Board of Tax Appeals had suggested an unwillingness of the board to follow the law of a particular circuit court of appeals where review would lie,[17] it was the drastic limitations on judicial review of Tax Court decisions imposed by the Supreme Court in the *Dobson* case[18] which gave the Tax Court a clear legal base for refusing to follow most of the decisions of the court of appeals, if it chose. The problem which now remains is that, while Congress repealed the *Dobson* doctrine in 1948,[19] the Tax Court still considers itself at liberty to reject the precedents of the courts of appeal, if it wishes to.

In the *Dobson* case, the Supreme Court declared (1) that Tax Court decisions on questions of law were to be accorded finality so long as they had "a reasonable basis in the law,"[20] as distinguished from whether the Tax Court had applied "the correct rule of law";[21] and (2) "when the court cannot separate the elements of a decision so as to identify a clear-cut mistake of law, the decision of the Tax Court must stand."[22] Thus, the Supreme Court extended to review of decisions of the Tax Court the doctrine it had laid down in the bombshell case of *Gray v. Powell*[23] of judicial deference to "reasonable" interpretations of law by administrative agencies, instead of requiring the agencies to adhere to the correct rule of law.

of a nonjudicial duty. . . . Such review of a judicial, as distinguished from a legislative or administrative determination may be had as to either questions of law or fact. The proposed procedure, however, for reasons of policy and not of law, limits court review solely to questions of law as heretofore described. The above principles are of general application . . . and in adhering to such principles the committee feels that it is establishing an appellate procedure that is unquestionably constitutional." H.R. Rep. No. 1, 69th Cong. 1st Sess. 20 (1925). Senate Report No. 52, 69th Cong. 1st Sess. contains identical language.

[13] The "inverted pyramid" of judicial review of Tax Court decisions began with §1002 of the Revenue Act of 1926, 44 Stat. 110. It was modified to substantially its present form (Sec. 7482(b) of the Internal Revenue Code of 1954) by §519 of the Revenue Act of 1934, 48 Stat. 760.

[14] §1003(b) of the Revenue Act of 1926, 44 Stat. 110.

[15] §1003(a) of the Revenue Act of 1926, 44 Stat. 110.

[16] H.R.. Rep. No. 1, 69th Cong. 1st Sess. 19 (1925); S. Rep. 52, 69th Cong. 1st Sess. 36 (1926).

[17] See, *e.g.*, Mrs. Frank Andrews, 26 BTA 642, 649 (1932); Missouri Pacific R.R. Co., 22 BTA 267, 289 (1931); Southern Railway Co., 27 BTA 673, 688-89 (1933).

[18] See note 6 *supra*.

[19] See note 29 *infra*.

[20] The court stated: "[A]ll that we have said of the finality of administrative determination in other fields is applicable to determinations of the Tax Court. Its decision, of course, must have 'warrant in the record' and a reasonable basis in the law. But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body.'" (320 U.S. 489, 501).

[21] "In general, it is the function of the Board [of Tax Appeals] to determine the facts of a tax controversy on issues raised before it and to apply law to these facts; and it is the function of the reviewing court to decide whether the board has applied *the* correct rule of law." Black, J., speaking for a unanimous Court in the pre-*Dobson* days of *Hosmel* v. *Helvering*, 312 U. S. 552, 556 (1941). (Emphasis added.) That the reviewing court was to determine the correctness and not the reasonableness of Tax Court decisions on questions of law was expressly set forth by the committee reports on the Revenue Act of 1926: "The court upon review may consider, for example, questions as to the constitutionality of the substantive law applied, the constitutionality of the procedure used, failure to observe the procedure required by law, *the proper interpretation and application of the statute or any regulation having the force of law. . . .*" H.R. Rep. No. 1, 69th Cong. 1st Sess. 19, 20 (1925); S. Rep. No. 52, 69th Cong. 1st Sess. 36 (1926). (Emphasis added.) See also Paul, *op. cit. supra* note 6 at 775-79.

[22] See note 6.

[23] 314 U.S. 402 (1941). For a penetrating analysis of the impact of Gray v. Powell upon judicial review of administrative agency action see Schwartz, "Gray vs. Powell and the Scope of Review," 54 MICH. L. REV. 1 (1955). As Professor Schwartz there points out: "*Gray v. Powell* assimilates review of questions of statutory interpretation to questions of fact. That is a plain statement of its effect, no matter how courts or commentators may try to obscure its meaning. And it is because of its effect that *Gray v. Powell* is of such great consequence. It blurs the distinction between law and fact upon which the scope of review in our administrative law has been grounded. It drastically limits review not only of agency findings of 'fact' in the narrow, literal sense, but also of agency constructions of statute-law. The latter are matters which, under the traditional theory of Anglo-American judicial review, are matters more legal than factual in nature and hence for the courts upon review. By conveniently labeling them matters of application, rather than interpretation, our courts have continued to pay lip service to the form of the traditional theory. But the doctrine of *Gray v. Powell* tends to make the practical effectiveness of that theory a thing of the past in our administrative law." (pp. 19-20) See also Jaffe, "Judicial Review: "Substantial Evidence on the Whole Record." 64 HARV. L. REV. 1233, 1258-1261 (1951).

[24] 325 U.S. 365, 380, 381, 382 (1945). Mr. Justice Frankfurter concluded at p. 384: "If the issue presents a difficulty which it is peculiarly within the competence of the Tax Court to resolve and that court has given a fair answer, every consideration which led to the pronouncement in the *Dobson* case should preclude independent re-examination of the Tax Court's disposition. Regardless of what the question may be termed for

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The full implications of this curtailment of judicial review of Tax Court decisions were soon even more plainly articulated by Mr. Justice Frankfurter, concurring in *Bingham,* when he said: "The specialized equipment of the Tax Court and the trained instinct that comes from its experience ought to leave with the Tax Court the final say also as to matters which involve construction of legal documents and the application of legislation even though the process may be expressed in general propositions, so long as the Tax Court has not committed what was characterized in the *Dobson* case as a 'clear mistake of law.'

". . . Congress did not authorize review of all legal questions upon which the Tax Court passed. It merely allowed modification or reversal if the decision of the Tax Court is 'not in accordance with law.' But if a statute upon which the Tax Court unmistakably has to pass allows the Tax Court's application of the law to the situation before it as a reasonable one—if the situation could, without violence to language, be brought within the terms under which the Tax Court placed it or kept out of the terms from which that court kept it—the Tax Court cannot in reason be said to have acted 'not in accordance with law.' In short, there was no 'clear-cut mistake of law' but a fair administration of it."[24]

To these writers, the rule of *Gray v. Powell* carried the most disturbing and far-reaching implications. It threatened to alter our system of government under which the ordinary courts have been empowered to control government officials and administrative agencies to the extent of holding them to correct rules of law. In any event, the extension of the *Gray v. Powell* doctrine to judicial review of decisions of the Tax Court met with much criticism.[25] Also, it gave rise to confusion and unevenness of application,[26] and created a double standard of judicial review in the field of Federal taxation which clearly illustrated its practical shortcomings. Under this double standard there was limited review for the "poor man" who, by not paying an asserted tax, could litigate the issue only in the Tax Court. The "rich man," however, by paying the asserted deficiency and suing for refund in a Federal district court could obtain appellate review of whether the district court applied the correct rule of law.[27]

For our purposes, the limitation placed on judicial review of questions of law to a determination of the "reasonableness" of a rule of law applied by the Tax Court necessarily had a profound effect on the view of the Tax Court as to whether it should follow the precedents of the reviewing court. For under that rule the Tax Court became virtually free of judicial review on questions of law, free to fashion its own "general propositions" of Federal tax law, and even to overrule a court of appeals on questions of law which were not "clear-cut."[28]

Repeal of Dobson rule by Congress

In 1948, however, Congress extinguished the rule of *Dobson* and *Gray v. Powell* in the tax field. It provided in what seem to be perfectly clear and categorical terms that the courts of appeal shall have exclusive jurisdiction to review Tax Court decisions "*in the same manner and to the same extent as decisions of the district court in civil actions tried without a jury.*"[29] (Emphasis added.) This provision of law is now set forth in Section 7482(a) of the 1954 Code. The legislative history made it plain that Congress was now making explicit what it had originally intended by the Revenue Act of 1926, and that the *Dobson* rule was *"an abdication by the Supreme Court on behalf of itself and the circuit courts of appeal, of judicial authority conferred upon the courts by Congress."*[30] (Emphasis added.)

With the congressional repeal of the *Dobson* rule and the reinstatement of the duty of the courts of appeal upon review of Tax Court decisions to determine whether the Tax Court has applied the right rule of law, it would seem necessary to conclude that the Tax Court has become subject to review by a cognizable court of appeals equivalent to that of a district court. And thus there arises, it would seem, a correlative duty on the part of the Tax Court to follow the law as declared by the court of appeals for the circuit in which the tax return was filed.[31] Moreover, the further fact that since 1926 Congress has provided that the judgments of the courts of appeal upon such reviews shall be *"final,"* save for the exercise of discretionary review by the Supreme Court,[32] underscores, with all the power of that definitive word, this duty of obedience by the Tax Court. By according "finality" to judgments of the courts of appeal, Congress has charged the courts of appeal and not the Supreme Court with the normal and primary responsibility for review of Tax Court decisions.[33] The Supreme Court will grant certiorari only "in cases involving principles the settlement of which is of im-

purposes of review, the Tax Court's determination should be accorded finality. That the Tax Court has expressed an allowable opinion as to the meaning and application of a tax provision . . . should suffice to reinstate its decision, without opening the sluices to independent review by the circuit courts of appeal and by this court of multitudinous tax questions. Such is the principle or rule of judicial administration which should guide review of Tax Court determination." See also Paul, *op. cit. supra* note 6 at 841-42.

[25] Paul, *op. cit. supra;* Griswold, "The Need for a Court of Tax Appeals," 57 HARV. L. REV. 1153.

[26] See note 24 N.Y.U.L.Q. REV. 610-612 (1949).

[27] See remarks of Congressman Hobbs, 93 Cong. Rec. 79 A3279 (1948).

[28] See, *e.g.,* Brooklyn Nat'l Corp., 5 TC 892, 895 (1945); Estate of Edward P. Hughes, 7 TC 1348, 1350 (1946). In the Hughes case, the Tax Court declared: ". . . We are aware of the decision of the Second Circuit in Commissioner v. Bayne's Estate, 155 F2d 475, which differs from our interpretation of the decisions of the Supreme Court in Fidelity Philadelphia Trust Co. v. Rothensies, 324 U.S. 108, and Commissioner v. Field, 324 U.S. 113, and holds that those decisions require the inclusion in decedent's estate of the trust corpus where there exists a possibility of reverter, even if only by implication of law and irrespective of how remote such a possibility may be. We adhere to our position as expressed in the *Biddle, Fahnestock,* and *Hunnewell* cases, supra." (p. 1350). In the Brooklyn National Corporation case, the majority of the Tax Court declared: ". . . Perhaps these differences serve to distinguish the *Pembroke* case [a decision by the Court of Appeals for the Second Circuit, reversing the Tax Court]. But, if they do not, then, with all due respect to the Circuit Court of Appeals for the Second Circuit, to which an appeal in this case will lie, we decline to apply the *Pembroke* case here, because we think its application would be contrary to the law as written by Congress." (p. 895). One judge of the Tax Court dissented on the ground that the Tax Court should have followed the precedent of the Court of Appeals.

[29] §36 of the Act of June 25, 1948, c. 646, 62 Stat. 991, amending Sec. 1141(a) of the Internal Revenue Code of 1939. §36 is now codified within Sec. 7482(a) of the Internal Revenue Code of 1954. Sec. 7482 provides in relevant part as follows: "(a) *Jurisdiction.*—The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code. "(b) *Venue.*—(1) *In General.*—Except as provided in paragraph (2), such decisions may be reviewed by the United States Court of Appeals for the circuit in which is located the office to which was made the return of the tax in respect of which the liability arises, or, if no return was made, then by the United States Court of Appeals for the District of Columbia. (2) *By Agreement.*—Notwithstanding the provisions of paragraph (1), such decisions may be reviewed by any United States Court of Appeals which may be designated by the Secretary or his delegate and the taxpayer by stipulation in writing: (c) *Powers.*—(1) *To affirm, modify, or reverse.*—Upon such review, such courts shall have power to affirm or, if the decision is not in accordance with law, to modify or to reverse the decision of the Tax Court, with or without remanding the case for a rehearing, as justice may require.

(2) *To make rules.*—Rules for review of decisions of the Tax Court shall be those prescribed by the Supreme Court under Section 2074 of Title 28 of the United States Code . . . ."

[30] 94 Cong. Rec. 8500, 8501 (1948).

[31] Int. Rev. Code of 1954, Sec. 7482(b)(1).

[32] Int. Rev. Code of 1954, Sec. 7482(a).

[33] Compare NLRB v. Pittsburgh Steamship Co., 340 U.S. 498, 502 (1951).

portance to the public as distinguished from that of the parties, and in cases where there is a real and embarrassing conflict of opinion and authority between the circuit courts of appeal."[34] In sum, as a matter of law it is difficult to perceive that the Tax Court, in the light of the Congressional repeal of the *Dobson* rule, stands in a relation to the cognizable court of appeals which is in any way different from a Federal district court so far as the duty of obedience to the law declared by that appellate court is concerned.[35]

District courts follow courts of appeal

Let us be clear about this. There cannot be any doubt that a Federal district court is bound by the decision of the cognizable court of appeals in a particular case, subject to Supreme Court review.[36] Nor can there be any doubt that the decisions of the court of appeals for a particular circuit bind the district courts of that circuit in cases involving different parties but the same issues, that is, the same writings or factual situation.[37] Thus what is court of appeals' sauce for district court cases of the circuit would necessarily appear to be sauce for Tax Court decisions appealable to that circuit, also.

If we are talking law, as it would seem we should be, these would appear to be the legal principles involved. However, the Tax Court buttressed its action of refusing to follow the Court of Appeals in a successor case[38] also headed for that circuit, upon several highly refined arguments which appear to be mainly in the nature of policy argumentation or assumptions. It remained silent as to the impact of the Congressional repeal of the *Dobson* rule.

First, said the Tax Court in the *Lawrence* case, it had always "believed" that "Congress intended it to decide all cases uniformly, regardless" of the decisions of the courts of appeal.[39] In addition, "it cannot conscientiously change unless Congress or the Supreme Court so directs."[40] Why the Supreme Court should be regarded as more persuasive than a supervisory court of appeals whose decision is to be "final" under the applicable statutes is not indicated. And the Tax Court even went so far as to say that "Congress expected the Tax Court to set *precedents* for the uniform application of the tax laws, insofar as it would be able to do that."[41] (Emphasis added.) How the Tax Court can maintain this "belief" or position in the face of Section 7482(a) of the 1954 Code,[42] or how, if that statute were considered by the Tax Court, its "belief" might be colored or altered, is not stated. It would appear that the Tax Court, in its desire as a matter of internal policy to decide cases "uniformly" without regard to the courts of appeal, has failed to consider that it is subject to review by the courts of appeal "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury," believing that what it regards as sound policy, is law also.[43]

If we look at the position of the Tax Court from the standpoint of its place in our judicial system, the fact is that responsibility for the uniform administration of the tax law is not committed to the Tax Court all by itself, but rather, depends upon several factors. First is the factor of residence; and second is a choice of forum combined with residence as between the Tax Court, the district courts, and the Court of Claims. The statutes provide that a taxpayer may refrain from paying an asserted deficiency and sue in the Tax Court, or may pay the tax and sue for a refund in the district court of his residence or in the Court of Claims. While it is clear that an ultimate responsibility for uniformity belongs to the Supreme Court, it seems futile to assert or imply, in the face of Section 7482(a) of the Code, that the courts of appeal and these other tribunals are mere procedural conduits along the way to the Supreme Court, and have no real power of decision or right to exercise sovereignty. It also seems futile to assert that Congress has given power to the Tax Court to overrule the courts of appeal in some interest of "uniformity."

Finally, the Tax Court's belief in itself as a single court of national jurisdiction "uniformly" deciding tax cases seems open to question. In reality, the Tax Court is closer to being sixteen separate tax courts. The majority of its cases are decided by a single judge, and the sixteen judges of the court travel about and sit individually as divisions of the court in some 50 cities.[44] Decisions of the single judge become final unless the chief judge within thirty days directs review by the full court.[45] And, of course, such review is by the other judges of the court without having heard evidence, witnesses or oral argument.

As Dean Griswold has pointed out: "The result of this organization of the Tax Court, as every observer of the flow of Tax Court decisions knows, is a great deal of variation and inconsistency in the decisions of that court. In a good many cases it may be said, without thought of criticism, but merely as a statement of fact, that the result in the case depends in large measure on the particular judge who happened to be

[34] Layne & Bowler Corp. v. Western Well Works, Inc., 261 U.S. 387, 393 (1923); Revised Rules of the Supreme Court of the United States, Rule 19 (1), 346 U.S. 967 (1954).

[35] Although Sec. 7441 of the Internal Revenue Code of 1954 retains the concept of Sec. 1100 of the 1939 Code that the Tax Court is an "independent agency in the Executive Branch of the Government," in the words of Dean Griswold, "[T]his is a polite fiction that may once have served a purpose." He continues: "But the Tax Court is in organization, tradition, and function a judicial body, and should be treated as such in any survey of judicial review in tax cases." Griswold, "The Need for a Court of Tax Appeals," 57 HARV. L. REV. 1153, 1154 (1944). And there are many judicial statements that while not a Constitutional Federal court, the Tax Court performs inherently judicial functions and exercises powers wholly judicial in character. See, *e.g.,* Reo Motors v. Commissioner, 219 F. 2d 610 (6th Cir. 1955); Stern v. Commissioner, 215 F. 2d (3rd Cir. 1954). See generally, Brown, "The Nature of the Tax Court of the United States," 10 U. PITT. L. REV. 298 (1948). Finally, as a matter of legislative history, it should be remembered that in 1923 the Secretary of the Treasury proposed the creation of a Board of Tax Appeals within the Treasury Department, *Annual Report of Secretary of Treasury, Finance* 1, 10 (1923), and Congress responded by creating the board "as an independent agency in the Executive Branch of the Government," §900(k) of the Revenue Act of 1924, 43 Stat. 253, 336. And as early as 1926, the House and Senate Committee Reports on the bills providing for judicial review by the courts of appeal of decisions of the Board of Tax Appeals on questions of law commented that "the decisions of the board are judicial and not legislative or administrative determinations." H.R. Rep. No. 1, 69th Cong. 1st Sess. 20 (1925); S. Rep. No. 52, 69th Cong., 1st Sess. 37 (1926).

[36] In *Farmers & Merchants National Bank v. Wilkinson,* 226 U.S. 503, 506 (1925), the Court said: "The district court was bound to give effect to the decision of the circuit court of appeals." And in *Delaware L. & W. R. Co. v. Rellstab,* 276 U.S. 1 (1928), Holmes, J., speaking for a unanimous Court, said: ". . . the Circuit Court of Appeals has power to require its judgment to be enforced as against any obstruction that the lower court, exceeding its jurisdiction, may interpose." 276 U.S. 5. See also First National Bank v. Chicago Title & Trust Co., 207 U.S. 61, 66 (1907).

[37] In Noble v. Kavanagh, 66 F. Supp. 258 (E.D. Mich. 1946), the Court stated (at p. 259): "A decision of the Circuit Court of Appeals for the Sixth Circuit, construing the limitation provisions covering filing of claims for refund of taxes, as contained in the Internal Revenue Code, is binding upon district courts in the Sixth Circuit, including this Court, until reversed or overruled. Seattle-First National Bank v. United States, D.C. 44 F. Supp. 603, *affirmed* in 9th Cir., 136 F. 2d 676 and 321 U.S. 583, 64 S. Ct. 73, 88 L. Ed. 944." For other cases where this duty has been recognized, see A. H. Bull Steamship Co. v. United States, 141 F. Supp. 58, 60 (S.D. N. Y. 1956); Parker v. United States, 125 F. Supp. 731 (D. Colo. 1954); Consolidated Elevator Co. v. United States, 50 F. Supp. 781, 783 (D. Minn. 1943); United States v. Aluminum Co. of America, 44 F. Supp. 97, 158 (S.D. N.Y. 1942); Palmer v. Bender, 49 F.2d 316, 324 (W.D. La. 1931).

[38] Arthur L. Lawrence, 27 TC 713 (1957). In this decision the Tax Court indicated its concern about the *Stacey* case and apparently made its most serious attempt to bolster its position on this point with argument.

[39] "The Tax Court has always believed that Congress intended it to decide all cases uniformly, regardless of where, in its nation-wide jurisdiction, they may arise, and that it could not perform its assigned functions properly were it to decide one case one way and another differently merely because appeals in such cases might go to different courts of appeal. Congress, in the case of the Tax Court, 'inverted the triangle' so that from a single national jurisdiction, the Tax Court, appeals would spread out among 11

assigned to hear the case. . . . But apart from differences of approach in such matters, it is natural that the judges of the Tax Court should differ among themselves in the details of the construction and application of the tax laws. One judge is not bound by the decision of another judge unless it has been reviewed by the whole court. . . . [I]f he disagrees with the conclusion reached by one of his fellow judges in a memorandum decision, he is most likely to ignore the other case and follow his own view. Memorandum decisions are not cited by the court in its published opinions, and they are not regarded as having much binding effect under the general rule of stare decisis. *But they do represent more than two-thirds of the total number of cases decided by the Tax Court.*"[46] (Emphasis added.)

When to this is added the Tax Court's statutory duty to decentralize its adjudications for the convenience of taxpayers,[47] one may well conclude that the Tax Court has perhaps not as much right to view itself as a single, unified court as do the Federal district courts. Rather, the relationship of the sixteen judges to each other tends more closely to resemble that obtaining between the Federal district courts within a particular judicial circuit than it resembles the relationship between the members of an appellate court. All in all, it may be said that the Tax Court's refusal to follow precedents of the reviewing court of appeals in the interest of asserted national uniformity is one substantial factor among others which presently makes uniformity in the administration of the tax laws difficult and expensive.[48]

Which circuit controls?

Second, said the Tax Court in the *Lawrence* case, in support of its position, it does not know to what circuit a particular case may go on appeal, particularly because the parties may stipulate for any circuit. But does it really not know? Under Section 7482(b) of the Code.[49] Tax Court decisions may be reviewed by the court of appeals for the circuit in which is located the office in which the return was filed, and in practical terms that binds the petitioner as to his forum of appeal. It clearly marks the channel as to where the case may go from there. So far as a stipulation is concerned, it seems fair to assume in this highly practical world that since the case is appealable to the court of appeals of the petitioner's residence[50] and that court is favorably disposed either to him or to the Commissioner, neither party is apt to stipulate to go to some other circuit. And the fact that some Tax Court decisions may be appealable to more than one circuit, because they involve two or more taxpayers or different residences, appears to provide no reason why the Tax Court should not apply the law of a particular circuit to those cases which are, in all likelihood, appealable only to that circuit as of right. What objection is there to the Tax Court deciding a case involving two such taxpayers differently according to the law of the circuit of the filing of the return of each? The courts of appeal are bound to so decide them, later, if it does not.

Third, the Tax Court said that it is not always possible to discern the position of the court of appeals. But can any more be said about discerning the position of the Supreme Court of the United States? And this argument does not bear on why the Tax Court should not follow the court of appeals when the court's decision on a point of law is clear as crystal or even reasonably clear.

Above all, the Tax Court remained silent as to the applicability of Section 7482 (a) of the Code.[51]

It seems to the writers that this refusal of the Tax Court to follow, in a case appealable to a particular circuit, the law of that circuit as laid down by its court of appeals, is a departure from the applicable law. In addition, it poses disturbing questions in the broad field of judicial administration. There can be no real doubt that government officials who determine questions of fact and decide questions of law; administrative agencies which similarly sit in a *quasi-judicial* capacity to hear and determine questions of fact and law in an adversary proceeding of a *quasi-judicial* nature; and legislative courts which also try out questions of fact and law in proceedings of a judicial nature, are all under our system of government, integrated into a single Federal system of judicial administration. That system, in a vast country of 170 million people, is on the grand scale, with a single tribunal, the Supreme Court of the United States, at the apex of the pyramid, and the courts of appeal just below it. Within this framework, appeals may be had primarily on questions of law;[52] and judicial review of the acts of government officials, legislative courts, and administrative agencies may ordinarily be had only on questions of law. Thus, the ultimate responsibility for uniformity on questions of law, under the broad aegis of Article III of the Constitution, is committed to the courts of appeal, at their level. The action of the Tax Court, in failing to follow the law as laid down by a supervisory court of appeals does not appear to be authorized by our system. If government officials and other inferior tribunals were free to disregard the law as laid down by courts of appeal, we would have no longer a government of laws, but rather one of men; and the judicial function would lose its supremacy and distinction.

Also, the law seeks certainty; and, in the writers' opinion, lawyers and judges

courts of appeal, each for a different circuit or portion of the United States. Congress faced the problem in the beginning as to whether the Tax Court jurisdiction was to be local or nation-wide and made it nation-wide. Congress expected the Tax Court to set precedents for the uniform application of the tax laws, in so far as it would be able to do that. Hearings before Ways & Means Committee, Revenue Act 1926, pp. 10, 869, 878, 911, 926, 932; H. Rept. No. 1, 69th Cong. 1st Sess., pp. 17-19; Congressional Record, Vol. 67, pp. 1136-7, 3749 (1925)." (27 TC 718.)

[46] 27 TC 720.

[47] See note 39 *supra.*

[48] See note 29 *supra.*

[49] The reliance placed by the Tax Court on legislative history (see note 39 *supra*) is confined solely to the Revenue Act of 1926, and wholly ignores congressional repeal of the *Dobson* rule in 1948. And as has been pointed out in a penetrating student law review comment on the *Lawrence* decision, the legislative history of the 1926 Act does not evidence Congressional intent that the Tax Court should establish precedents for uniform application on a nation-wide basis. "Testimony in early hearings on appellate review was almost entirely directed toward uniformity within the Tax Court itself. Both the Committee reports and the hearings are silent on the problems of stare decisis and multiple review bodies." "The Tax Court, the Courts of Appeals and Pyramiding Judicial Review," 9 STAN. L. REV. 827, (1957).

[50] Int. Rev. Code of 1954, Sec. 7443(a), 7444(c), 7446. See Rule 26 and Appendix II to Rules of Practice of the Tax Court, 26 U.S.C.A. following §7453 (1955), for a list of some 50 cities throughout the United States where the Tax Court may hold hearings.

[51] Int. Rev. Code of 1954, Sec. 7460(b).

[52] Griswold, *op. cit. supra* note 25 at 1171-72.

[53] Sec. 7445 of the Internal Revenue Code of 1954 provides that "The principal office of the Tax Court shall be in the District of Columbia, but the Tax Court or any of its divisions may sit at any place within the United States." Sec. 7446 provides that "The terms and places of the sessions of the Tax Court and of its divisions shall be prescribed by the chief judge with a view to securing reasonable opportunity to taxpayers to appear before the Tax Court or any of its divisions, *with as little inconvenience and expense to taxpayers as is practicable.*" (Emphasis added.)

[54] See Comment, "Heresy in the Hierarchy: Tax Court Rejection of Court of Appeals Precedents," 57 COL. L. REV. 717 (1957).

[55] See Note 29 *supra.*

[56] Under Sec. 6091(b) of the Internal Revenue Code of 1954 tax returns ordinarily are filed in the Internal Revenue district in which is located the taxpayer's legal residence (individuals) or principal place of business or principle office (corporations).

[57] See note 29 *supra.*

[58] See vom Baur, *Federal Administrative Law,* I, (1942) §§249, 425.

[59] "The interpretation of tax statutes is a function in which the tendency to apply the doctrine of stare decisis is unusually strong." Attorney General's Committee on Administrative Procedure, *Administrative Procedure in Government Agencies,* S. Doc. No. 8, 77th Cong., 1st Sess. 466.

[60] Charles Dickens, *Oliver Twist,* ch. 51.

[61] See note 2, *supra.*

should always strive for certainty to the extent that certainty is possible. The whole foundation and structure of society, and particularly of business and commerce, rest to a very high degree upon certainty in the law. Stability in the understanding and administration of the tax laws is particularly necessary.[53] If judges care enough about it, it is usually possible to render decisions which will provide a relatively high degree of certainty to litigants and the public.

Apart from logic and applicable legal principles, what usefulness can be served by the action of the Tax Court? Let us look at the consequences of its refusal to follow the law laid down by the Sixth Circuit in a case clearly appealable to that circuit. The unsuccessful petitioner, instead of winning his case as he would have if the law of the Sixth Circuit had been applied to put a probable end to the litigation, now has to pay the asserted deficiency or post a bond in order to be able to appeal to the Sixth Circuit. That may cause him financial hardship. But he manages to appeal; and he has to pay counsel, and pay the printer also for reproducing part, at least, of the record. Oral arguments may be had; travel expense may be involved; an opinion finally appears; and in due course, what happens is what everybody knew all along would happen: he wins his case. Certiorari would probably not be sought or would probably be denied; the mandate of the Court of Appeals would finally go down the line to the Tax Court; sooner or later the taxpayer would obtain a refund, or the case would be closed.

But, if you were the taxpayer, how would *you* feel? You would probably be unhappy, and confused. Or as the taxpayer's counsel, what would you tell him if he asked you *why* he had to go through all those motions when everybody knew in advance what the Sixth Circuit would do with his case? We doubt that he could be convinced that any useful purpose had been served. Indeed, he might be inclined to say, like one character of fiction, that "The law is a ass—a idiot."[54]

Finally, the law applicable to the role of the Tax Court in this situation, if there is more doubt about it than the writers think there is, when these key statutes are considered, should be settled by the Supreme Court. It is futile for any judicial system to tolerate the economic waste which has been generated by these decisions. Our judicial system is enough under attack as it is. The Supreme Court now has the opportunity, in the *Sullivan*[55] case in which certiorari has been granted, to set things straight, although this question of judicial administration was not raised in the petition for certiorari. In any event, in this problem of judicial administration, the Tax Court should follow the law. It does not appear free to fashion its own policy in that area. ☆

New procedural decisions this month

Must sue same District Director who received tax. Taxpayers paid their taxes to a District Director who died thereafter. They brought suit, however, against the successor director. The district court dismissed and this court affirms. The payment to the predecessor director and not the denial by the present director is what gives rise to the cause of action. A suit against the District Director is personal and neither the United States or the successor director are parties. The court remarks that the correct remedy of the taxpayer would have been a suit directly against the United States, but that the statute of limitations has now run on such a suit. *Bhul,* CA-6, 1/23/58.

Based refund claim on goodwill value; "amendment" raising real estate value is new claim [*Certiorari denied*]. Taxpayer was formed by the merger of several companies in 1925. Its excess profits tax invested capital included the value of stock of the merging companies paid in for taxpayer's stock. The taxpayer filed a claim for refund on the ground that in valuing those stocks by valuing the assets they represented the Commissioner erred in his computation of goodwill. Subsequently, it filed an amendment claiming error in the valuation of land and buildings of those merged companies. The Court of Claims held that the "amendment" raised a new issue and was a new claim. It agreed that the Commissioner was wrong in the real estate valuation, but since the claim was not made within three years of the filing of the return, only payments within two years of the filing of the claim can be refunded. *General Outdoor Advertising Co., cert. den.* 12/9/57.

Delivery of Tax Court petition to Federal official is not mailing. Taxpayer was an inmate of a Federal penitentiary. He signed a petition to the Tax Court contesting an asserted tax deficiency and delivered it to a prison official with the request that it be sent registered mail; he also furnished the official proper postage. This was done 12 days before the expiration of the 90-day filing period. However, the petition was not received at the Tax Court until after the period had expired because of delay in the prison mail room. The taxpayer relies on 1954 Code Section 7502 that timely mailing is treated as timely filing. However, that section by its terms is to be applied only if the postmark date is timely, which was not the case here. Thus, the Tax Court's denial of jurisdiction is affirmed. One dissent: Section 7502 is not to be read that literally. Delivery to a proper Federal official for mailing should be sufficient. *Rich,* CA-5, 12/12/57.

Agreement not a statutory closing; but equity bars refund. The court below directed a verdict for the Government in taxpayer's refund suit. The taxpayer had agreed, in settlement for a tax year, not to sue for refund, signing form 870-AD. The agreement is not binding, because it was not the closing agreement signed by the Secretary, the only statutory way to close a year. However, the district court held that equity bars a refund. The Commissioner relied on that agreement and forebore additional tax and negligence penalties he had once asserted. It would be unfair to permit taxpayer to sue now that Commissioner's time for assessment had passed. This court affirms. One dissent: the holding permits the IRS to by-pass the statutory procedure for closing agreements. Relaxation of statutory requirements is up to Congress. *Daugette,* CA-5, 12/26/57.

"Tentative" return not a statutory return. A tentative return filed by an individual within the permissible period which did not include the correct gross income, or any deductions, or credits does not meet the statutory requirements of a return. Since taxpayer made no effort to show any reasonable cause for his failure to file a proper timely return, the court upholds the delinquency penalties. One dissent without opinion. *Chesterfield Textile Corp.,* 29 TC No. 73.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Office manager who informed on boss got $69,000 fee

HERE'S A SAD little story, which just goes to show that it's hard to tell whose ox is being gored, or you never can tell what will happen when playing the odds with the tax collector. On page 241 of this issue there is a report on a rather dull little case about the application of the spreadback rules to a receipt of some $68,837.96. The taxpayer lost, he had to include the entire amount in the year of receipt and had a deficiency of some $18,000 in addition to the tax originally paid of about $17,000. Still he netted $33,000—all for reporting his employer's tax fraud to the IRS, apparently after he had been fired. Here's the story as set out in the findings of fact and the opinion (*Faul,* 29 TC No. 49).

"From approximately February, 1941, to March, 1946, Faul was employed full-time as office manager by the R. E. Myers Company, of Salinas, Monterey County, California. The R. E. Myers Company was a subsidiary of the Salinas Valley Ice Company. . . .

"Following 1942, Faul asked his employer, Ralph Myers, why he was cheating with his books and exposing himself to a charge of fraud. Faul further stated that he did not wish to remain with Myers and continue to be exposed to such conduct. Myers regarded the objections lightly and assured Faul that he would 'have someone else do it.' At that time he hired Emmett Gottenburg, a certified public accountant. Gottenburg kept the tax records and prepared the tax returns for the above-named companies.

"In 1944, Faul went to San Francisco to talk to 'some Government man' about what he should do to protect himself. He was told that he should make records and have evidence so that he would not be exposed.

"In order to shield himself, Faul, working in his home and in the office late at night, commenced to compile records in February or March of 1944. He continued with this recordmaking for the remainder of 1944 and during 1945 and part of 1946.

"There is no evidence either as to the identity of the 'Government man' contacted by Faul in 1944 or that they conferred on any subject other than how Faul might protect himself. The record does not show that Faul identified his employer at this conference.

"Faul was discharged by the Myers Company in March, 1946. Thereafter he determined to submit evidence of the alleged fraud to the Government, and on February 22, 1947, he had an interview in San Francisco with John Boland, Chief Field Deputy in the office of the Collector of Internal Revenue, San Francisco, California. At that time, he submitted to Boland a memorandum of 45 alleged violations of internal revenue laws by the Salinas Valley Ice Company. On the same day Faul filed a claim for reward on a Form 211. Additional information supplied by Faul between April and July of 1947 increased the allegations to a total of 68 or 70.

"Alan Russell Shurlock . . ., an internal revenue agent, commenced an audit of the Salinas Valley Ice Company in May, 1947. He was in contact with Faul concerning the list of allegations during the summer and fall of 1947. . . . He submitted his final report on the Salinas Valley Ice Company in July, 1948. The case was then forwarded to the conference section in San Francisco. . . .

"In April, 1952, Faul received a check in the amount of $68,837.96 as an informer's award. The award was paid from the appropriation for salaries and expenses, Bureau of Internal Revenue. . . ." ☆

New fraud and negligence decisions

Fraud penalty upheld on failure to file returns. For nine years taxpayer failed to file returns or pay taxes although he knew he was in receipt of taxable income. His explanation was that he did not approve of the wasteful manner in which the Government was spending tax money. This court affirms the imposition of the 50% fraud penalty. The failure to file returns is persuasive evidence of fraudulent intent. *Powell,* CA-9, 1/13/58.

Criminal tax case delayed until civil liability determined. When taxpayer was indicted for criminal tax fraud, the Government levied a jeopardy assessment against him, leaving him with no assets. Taxpayer claimed that without assets he could not afford to hire an accountant to prove his defense in the net worth criminal case. This court dismissed the case on the grounds that without an accountant taxpayer could not get a fair trial. The Seventh Circuit reversed. The defendant now moves to delay trial of the criminal case until after the civil liability has been determined. The court grants the motion. The court says that the Government's policy of trying criminal liability before civil is not binding on it. *Brodson,* DC Wis., 10/8/57.

Court allows over-ceiling costs offsetting unreported over-ceiling sales. Asserted deficiencies and fraud penalties against a candy broker who failed to report substantial income from commissions, from over-ceiling sales of candy, and from a partnership business are upheld but the court reduces the deficiencies by allowing as a cost an estimated amount of over-ceiling payments on candy purchases. *Zeddies,* TCM 1958-14.

Tax evasion motive is essential element in crime of evading payment of withholding taxes. A judge sitting without a jury convicted defendant of the crime of willfully attempting to defeat and evade the payment of some $120,000 withheld taxes of employees of his family corporation. The judge considered that the fact he paid trade creditors first in an effort to keep the business going established the element of willfullness. However, the returns were filed and he conferred frequently with IRS officials on the proposed payments. This court reverses and remands for a new trial. The test is the same whether the crime is evasion of one's own taxes or of with-

held taxes: it must be proved that the acts were done with the motive of evading taxes. The term "willfully" as used in criminal statutes refers to an evil motive, bad purpose or corrupt design. The lower court's conviction cannot be sustained without a finding of some element of attempted evasion. *Wilson,* CA-9, 11/14/57.

Expert advice reasonable cause for not filing estimate. Prior to 1951, taxpayer took no part in the operation or management of the family business. Due to death of the managers, he took over supervision and received a salary as well as dividends. He consulted the CPA-attorney who had advised the firm for many years and had prepared the tax returns for it and the family. He told taxpayer that he need not file a declaration of estimated tax. The court finds that the CPA-attorney was highly qualified as a tax advisor and that taxpayer's reliance on his advice was a reasonable cause for his failure to file. No penalty is imposed. *Johnson,* DC Ore., 11/15/57.

Bank must produce records for customer's tax audit. A bank refused to obey a summons to produce records of a customer's accounts and those of his wholly owned corporation. Its grounds were that the statute of limitations had run against the years the revenue agent requested to examine and also that the records of the corporation were not relevant. The court orders production of the documents. The early years might be open to a deficiency if there was fraud, and the corporate records are needed to trace through certain individual transactions. *Foster,* DC N. Y., 1/23/58.

Conviction for failure to pay despite timely filing. The court notes that this is apparently the first case in which a taxpayer was prosecuted for failure to pay. The indictment charged wilful failure to pay 1953 and 1954 tax; every year since 1948 taxpayer delayed payment of tax (ranging from $2,000 to almost $8,000 a year) from three to four years. After conviction, the taxpayer moved for acquittal on the ground that the delay was not wilful. The court follows *Spies* (317 U.S. 492) in which the Supreme Court said that wilfulness includes evil motive and want of justification and *Murdock* (290 U.S. 389) which stressed stubborness, perversity and careless disregard. Noting taxpayer's luxurious living while he owed the tax money, and the constant repetition of the offence, the court concludes that failure to pay was wilful and denies the motion for acquittal. *Palermo,* DC Pa., 12/5/57.

Bookmaker's losses disallowed for failure of proof. The Commissioner disallowed for lack of substantiation alleged losses claimed to have been sustained from wagering operations conducted by various partnerships of which taxpayer was a member, and by taxpayer as a sole proprietor. All the underlying records of the operations were destroyed. Such records as were maintained consisted of alleged weekly summaries made from the destroyed primary records. The court concludes taxpayer has not established that the retained summary records accurately reflect the results of the wagering operations, and sustains the Commissioner's disallowance. Negligence and estimated tax penalties are upheld. *Fogel,* TCM 1957-228.

Deficiency, but not fraud penalty, upheld on basis of unrecorded deposits. Taxpayer operated a soft drink bottling company as a sole proprietorship. The Commissioner alleged that numerous and comparatively large deposits made by taxpayer in a personal bank account, the sources and nature of which were not recorded or accounted for, were unreported income. Since taxpayer had the burdens of showing that the deposits were not income, and he did not successfully meet that burden, the deficiencies are upheld. However, the court points out that the Commissioner had the burden of proving fraud, and the mere showing that there was a failure to report as income items which could in some part have been either income or nonincome items does not establish that by reason of their omission, the returns were false and fraudulent with intent to evade tax. *Jones,* 29 TC No. 66.

Stockholders fraudulently diverted corporation's earnings from forgery. Taxpayers here had been convicted of filing false corporate returns. They were stockholders of a corporation which forged City of St. Louis cigarette sales tax stamps on cigarette packages. Taxpayers charged the customers the total legal tax and by use of a counterfeit dye falsified the records given to the city and turned in only the amount collected by check. The customers of the corporation paid part of the fee by check (that amount was properly accounted for) and part in cash which the stockholders kept. The court finds no error in the trial below and affirms the conviction. *Giardano,* CA-8, 11/8/58.

Deficiencies and fraud penalties sustained after criminal conviction. The Commissioner asserted deficiencies against taxpayer for substantial understatements of income for 1945 through 1951, for which years taxpayer had been convicted of evasion. Taxpayer's explanation had been that his wife had given him $25,000. In 1951, however, when taxpayer filed an answer to his wife's complaint for divorce, he specifically denied that he had ever received large sums of money from her. Taxpayer did not appear or offer evidence. The court sustains the deficiencies and fraud penalties. *Thompson,* TCM 1958-7.

Fraud penalties sustained for failure to report sales. The imposition of fraud penalties against a corporation and its principal stockholders for failure to report substantial sales over a three-year period is upheld. The evidence showed that many customers were required to pay cash; invoices for these sales were numbered out of their regular order; in one instance, a customer was requested to maintain falsified records; items were erased on bank statements; and false and inconsistent statements were made to investigating agents. One dissent without opinion. *Chesterfield Textile Corp.,* 29 TC No. 73.

Numerous realty sales result in ordinary income; installment method denied because records lacking. The Commissioner's use of the net worth method was held by the Tax Court fully justified as evidence of the correct income of taxpayer, a real estate operator, who omitted earnings from sales of real estate. These sales were held to result in ordinary income rather than capital gain; taxpayer sold 58 pieces of property in a seven-year period, and acquired additional property for the construction of homes. Since taxpayer's records were wholly inadequate to show income under any accounting method, he was denied use of the installment method for reporting such sales. Fraud penalties and the penalty for substantial underestimation of tax were sustained. This court affirms. *Anderson,* CA-5, 12/6/57.

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

How to achieve flexibility in pension and profit-sharing plans

by **ALVIN D. LURIE**

Tax men dealing with pension and profit-sharing plans must be familiar with more than the details of Treasury requirements—they should have a broad grasp of the practical operation of restrictions and be able to counsel wisely on the choice of plan and fundamental provisions. Mr. Lurie, New York attorney, presented a survey of such matters at the Eleventh Annual Alabama Federal Tax Clinic, giving special attention to what to do when plans are suspended, discontinued, or upset by mergers. His analysis of the flexibility that can be achieved even with pension plans evoked considerable interest in the audience. The following is his paper from that meeting. A detailed treatment of the subject is contained in his article which is to appear in a forthcoming issue of the Yale Law Journal.

CONGRESS has provided specific requirements in the Code for a "qualified" plan. "Qualification" means that the trust utilized to effectuate the plan is exempt from Federal income taxation. Even more important, however, contributions by the employer to a qualified plan may be deducted as made, and the employee need not report the contributions as income until he actually receives them in the form of a distribution under the plan; even then the employee may in some circumstances be entitled to capital gain treatment of the distribution. There are, of course, unqualified plans, over which the Service has no jurisdiction. But the aforementioned tax attributes of qualified plans are so attractive that unqualified plans are the exception, and we will confine ourselves to the "rule" here.

Qualification — Code provisions

A plan (whether or not operating through the instrumentality of a trust) will be "qualified," as that term is used in the Code, if: (a) the plan is created by an employer for the exclusive benefit of its employees and their beneficiaries; (b) contributions are made to the plan, whether by the employer alone or together with the employees, for the purpose of building up a fund for distribution to the employees or their beneficiaries; (c) diversion of such fund is impossible under the trust terms; and (d) neither the determination of employee eligibility under the plan nor the computation of contributions or benefits discriminates in favor of employees who are officers, stockholders, supervisory personnel, or highly compensated employees.

The employer is free to establish any basis of employee classification for purposes of coverage under a qualified plan provided that the classification does not have the effect of discriminating in favor of the top-drawer groups just named. Discrimination in *any* manner is not barred by the statute. Thus, limitation of eligibility to salaried persons is not discriminatory *per se*. Classifications based on age, length of service or employment in certain designated departments may also qualify. Irrespective of classifications, a plan will satisfy the coverage requirements if 70% or more of all employees (with certain exceptions for new employees, and for part-time and periodic employees) participate in the plan. If 70% of the employees are eligible to participate, but all do not elect to participate, the plan will qualify if at least 80% of the eligible employees actually participate.

Qualification depends upon the plan's being nondiscriminatory not merely in the matter of coverage but, also, "contributions *or* benefits." The statute deliberately uses the disjunctive between the words "contributions" and "benefits," because in case of pension plans the *contributions* will inevitably discriminate in favor of the older—and, presumably, more highly compensated—employees, but it is enough for qualification that the *benefits* do not discriminate.

Treasury position

There we have the bare bones of the statute. Actually, however, the Treasury's rules for qualification of pension and profit-sharing plans are considerably more extensive. Proceeding on the theory that pension plans exist by legislative sufferance, in view of the tax subsidies Congress has written into the Code for such plans, the Treasury has issued a staggering volume of rulings, regulations, opinions, mimeographs, and releases, in which it has "laid down the law" in this field. In April of last year, the Treasury compiled a summary of its views on some of the more common issues. This compilation runs 24 pages of small print in the Internal Revenue Bulletin, is broken down into over 50 topics, and is followed by an appendix of 47 rulings, which it incorporates by reference, and 68 releases under the 1939 Code, substantially all of which remain effective under the 1954 Code.

With this welter of words behind him, it is obvious that the revenue agent auditing a company's deduction for a contribution to a profit-sharing or pension plan will not stop with the inquiries "is it ordinary?" and "is it necessary?" as in the examination of other types of business deduction. He wants to know about the vesting schedule and forfeitures, the classification of employees, waiting periods and salary bases, provisions for increments, investments of trust assets, and all the other diverse matters that go into the makeup of a retirement plan. It is by no means clear that such a role for government is appropriate, or that it is even contemplated by the statute.

Pensions and profit-sharing are, after

all, merely forms of deferred compensation. The only clear interest of Congress would appear to relate to the maximum amount of such deferred compensation for which the employer will be permitted to claim a current deduction, and the amount put into the deferred compensation fund on which an employee will be permitted to defer reporting tax. These are matters which could be stated by explicit rule, viz., 15% of salary, or could be left to the "reasonableness" tests that govern compensation generally; and such other matters as discrimination, diversion, disguised dividends, etc. could be left to the "ordinary and necessary" and "constructive dividend" tests.

Instead of this, we have seen the development of elaborate rules for "qualified" and "unqualified" plans—rules largely of the Treasury's own devising—and have had the employer's deduction related directly to this matter of qualification. Perhaps there is justification for the application of all these rules in determining the exemption of the employees' trust from income tax; but none is apparent for tying the employer's deduction to these rules.

Pensions vs. profit-sharing

What makes one company choose a pension plan while another company chooses a profit-sharing plan? There is, of course, a fundamental difference in philosophy between the two, a pension plan being designed "to provide systematically for the payment of definitely determinable benefits . . . after retirement," while a profit-sharing plan is designed "to provide for participation in profits . . . after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event," not necessarily retirement. Each employer must decide for itself whether its employees are likely to be more responsive to the *security* inherent in the definitely determinable retirement benefits of a pension plan or the *entrepreneurial* incentive sparked by a sharing in the employer's current profits.

Actually, this may overstate the case for profit-sharing, because each employee's share of profits in any year can be no more than 15% of his compensation for that year—at least, the employer cannot deduct a contribution in a greater amount. On the other hand, it is possible in a profit-sharing plan to provide that the funds forfeited by any employees leaving the company before their benefits mature shall be reallocated among the remaining employees; so in this way the real shares of profits for long-standing employees can be very significant indeed. Forfeitures of other members' shares of the fund cannot be reallocated in a pension plan, because that would defeat the pattern of definitely determinable benefits which is the essence of a pension plan.

In any event, it is rare that the choice between a pension plan and a profit-sharing plan is predicated on a preference of the employer for his employees' retirement security over their participation in profits, or vice versa. Also of relatively minor importance in the choice between pensions and profit-sharing is the desire to provide retirement benefits, as distinguished from deferred benefits realizable *before retirement*, since the bulk of profit-sharing plans are of the retirement type, differing from pension plans mainly in the basis for making contributions and in the lack of certainty of the amount of the retirement benefit.

A far more important consideration in choosing plans is the ease of giving recognition to an employee's length of service in a pension plan—even service in years before the plan was established. While the Service has approved profit-sharing plans containing a length-of-service factor that gives credit in the allocation of contributions not only for relative compensation of participants, but also for relative length of employment, the tendency of any such formula towards discrimination in favor of highly compensated employees generally discourages attempts to devise a profit-sharing plan where recognition of past service is the object. On the other hand, it is quite normal in a pension plan to provide for a pension equal to 1% of compensation for each year of employment before the plan began and 1¼% for each year of employment after. This has obvious appeal where the employer's stockholders have the most service before the plan's beginning.

Sometimes a pension plan provides simply for a fixed retirement benefit regardless of the number of years of employment, for example, 35% of the average of the last five years' compensation. Where the employers' stockholder-employees or other most highly regarded employees are within a relatively few years of retirement when the plan is begun, they can be given their full pension at retirement the same as if the plan had been in force during all their working years. There is nothing comparable to this that can be achieved with a profit-sharing plan.

Flexibility

Probably the main determinant of whether to institute a pension plan or a profit-sharing plan for the typical employer is its attitude towards the basis for fixing contributions. In the case of pension plans, this is the actuary's handbook; in the case of profit-sharing, the accountant's profit and loss statement. Pension plans impose a more or less fixed commitment on the employer to contribute the amount actuarially determined to be necessary to provide the benefits after retirement. In case of a plan funded by individual insurance company contracts for each employee, the employer's contribution is the aggregate of the fixed insurance premiums. In a self-insured plan, the actuary's computation from year to year measures the contribution; but this is fixed too, in the sense of depending on the actuarial assumptions, rather than the employer's whim or ability to pay.

In case of a profit-sharing plan, however, the contribution is tied only to the availability of profits. In other words, the plan will normally provide for a contribution of, say, 10% of the year's profits to be divided ratably among all employee participants. In fact, the Regulations under the 1954 Code even permit the qualification of a profit-sharing plan with no fixed formula for profit-sharing. Of this, more anon. But even with a formula, the employer knows that it will have no obligation under the plan if there are no profits. It is for this reason that many small companies prefer profit-sharing to pensions, for they feel more comfortable about committing themselves to put even 50% of their profits into the retirement fund than about making a commitment to contribute perhaps less than half of this amount to a pension plan when there are no profits.

Options in actuarial computations

Actually, the commitment for a pension plan is not as inflexible as is sometimes supposed. Under the Code two competing actuarial approaches to the funding of pension plans are recognized. One, level funding of past and current service credits, involves the distribution of the remaining cost of past and current service credits as a level amount, or level percentage of compensation, over

the remaining future years of service of the employees. The other, the so-called normal cost and accelerated funding of past service method, requires a contribution to be made for what would be the current year's cost if the plan had been in force from the earliest year of credited past service, called the "normal cost," to which may be added not more than 10% of the actuarial deficiency, which is the cost of all the unfunded past service credits.

There is a considerable range of sums that might constitute the contribution for any year, not only as between these two methods, but under either of them, because of the numerous delicate actuarial decisions that go into the determination of any year's contribution. Certain funding assumptions might permit a corporation to get ahead on its contributions in highly profitable years, or conversely to coast in lean years. (This, of course, assumes that the plan is self-funded; because if it is funded by annuity contracts with an insurance company, then the required contribution will generally be a constant amount equalling the annual premiums; although insurance companies sometimes permit skipping or catching-up on premiums to accommodate temporary business conditions, or borrowing against insurance policy cash values to meet premiums.) The cases have been rather liberal in allowing for the full play of the actuaries' judgment in fixing the amount of the contributions.

Suspending contributions

There is this further opportunity for flexibility, in dealing both with pension plans and with profit-sharing plans: in a year of poor profits or a cash squeeze, the employer may temporarily suspend contributions to the plan. That is something that should never be done lightly, because the suspension can cause retroactive disqualification of the plan, if it is regarded as indicative of the lack from the very inception of a bona fide, permanent plan for the exclusive benefit of employees in general; or the suspension of contributions may be regarded as tantamount to a termination of the plan, with the result that funds of the plan must be distributed—although not necessarily at once, so long as the plan of distribution does not discriminate in favor of officers, shareholders, supervisors or highly compensated employees.

A temporary cessation of contributions need not have either of these dire consequences of retroactive disqualification or termination. In case of a pension plan, the temporary suspension of contributions can be without any consequences so long as (a) the benefits under the plan are not affected by the suspension, and, (b) if the plan calls for benefits for service prior to inception of the plan, the remaining unfunded past service cost does not exceed the cost of such past service which was unfunded at the time of establishment of the plan. This normally means that, insofar as past service cost is concerned, payment of an amount equal to interest on the unfunded cost is sufficient.

A temporary suspension of contributions to a profit-sharing plan, however, is more serious. There is no rule-of-thumb test which will assure continued qualification of the plan. It is essential to advise the District Director of Internal Revenue of the suspension and to request a redetermination regarding the qualification of the plan. Revenue agents tend to look askance at the suspending of contributions to a profit-sharing plan. Remember that these can occur only when the employer has the profits requisite for the contribution; for if there were no profits, the failure to make the contribution would not be a suspension. However, the existence of profits is not always tantamount to the availability of cash with which to make a contribution. While it has been held that the contribution may be made in the form of a negotiable promissory note, even the issuance of such a note may at times be embarrassing to a company from a credit standpoint. In such circumstances, where the suspension of contributions is obviously dictated by business exigencies, it has been my experience that a favorable determination of continued qualification of the plan can be secured from the local Director's office.

Nevertheless, it might be advisable to include a provision for full vesting of participants' shares upon the occasion of the suspension of contributions. The Treasury's rules require such full vesting upon a "discontinuance" of contributions, since vesting is necessary at the termination of a plan and the discontinuance of contributions is held to be in effect an informal termination of the plan. A mere temporary "suspension" of contributions to a profit-sharing plan which has not ripened into a "discontinuance" would not seem to be an informal termination; but the Service has specifically exempted from the "full vesting" requirement only suspensions of contributions to pension plans, leaving ambiguous the effect on vesting of suspending contributions to a profit-sharing plan.

Profit-sharing without formula

There is something of a paradox here, if the temporary suspension of the contributions required under the formula of a profit-sharing plan may cause its loss of qualification, or may precipitate full vesting, and in any event requires the submission of a request for redetermination of qualification, while a profit-sharing plan which is qualified without a contribution formula apparently contains no such hazards in the event of the failure to make a contribution in any particular year.

I personally tend to look upon the Treasury's dropping of the formula requirement as a dubious benefit. For many years, until very recently, the Treasury had tenaciously insisted upon a contribution formula as being necessary to comply with its requirements for a "permanent," nondiscriminatory plan. "Permanent" meant to the Treasury recurring contributions. After several losses in the courts the Treasury gave way on the need for a formula; but its Regulations still call for a "permanent" plan, and cite abandonment of the plan, as by the mere making of "a single or occasional contribution out of profits," as evidence that the plan was not a bona fide program for the exclusive benefit of employees. Thus, the Treasury has not embraced the principle of the famous *Lincoln Electric Company* case, which held that a single contribution was adequate for a qualified plan.

The Regulations expressly concede that "it is not necessary that the employer contribute every year," or contribute the same amount, or in accordance with the same ratio, from year to year; but "recurring and substantial contributions out of profits" are required. Moreover, the Regulations warn that a plan does not qualify, whether or not it contains a formula for profits, "if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates" in favor of officers, stockholders, etc.

Therefore, the execution of a plan without a profit formula at the very least stamps the plan as potentially vulnerable, and may actually be the seed of the plan's own destruction. With a

formula in a plan approved by the Director, you are reasonably assured that if you adhere to the formula, your plan will continue qualified. But there can never be certainty of tax status in a plan without a formula. There is no standard against which the occurrence of a suspension can be measured. The reduction of contributions in a particular year may be regarded as discriminatory. Failure to make an contribution may question permanency.

The absence of a formula, apart from creating uncertainty, actually encourages abuse, for it might lull the employer into the assumption that any pattern of contributions was permissible. In case of my clients, where they want some latitude for contributions, I provide a minimum and a maximum contribution—for example, "not less than 5% nor more than 15% of profits, as the directors shall decide from year to year."

One other undesirable feature of a no-formula plan is the necessity of establishing the liability of the employer for each year's contribution before the end of the tax year, presumably by a director's resolution fixing the amount of the contribution, or the method of determining it. In the absence of satisfactory evidence that this has been done, the contribution might not be deductible. In case of a plan containing a definite formula, the plan itself establishes the liability.

Continuation of trust

The question has been considered by many lawyers, but no judges, whether an employees' trust can be continued after contributions have been permanently discontinued. Several circumstances might give rise to this situation: viz., the employer might be compelled by financial circumstances or personnel considerations to discontinue contributions; the employer coming out of a military buildup period may have laid off all but its stockholder-employees and may fear that continued contributions to a trust in which its stockholders are the only remaining participants will not be deductible; or the employer may have been liquidated and dissolved. In all of these cases, it would obviously be very advantageous if the employees' pension or profit-sharing trust could be kept in existence as a *qualified* employees' trust, for any investments it makes would continue to enjoy tax shelter, and the participants could continue to defer the income represented by their trust shares.

The idea of keeping the trust in existence after the employer which gave it its life has been dissolved presents the most intriguing possibility. It is only slightly more preposterous than the acquisition by the pension trust of control of the employer corporation, which is already part of the recorded history of the American financial community. In what is essentially the converse of the posed case, the Service has ruled that a trust loses its qualification when there are no longer any employees covered by it. The ruling is based on the fact that the statutory requirement for qualification is predicated on the existence of a trust which is part of the plan of an employer for the benefit of his employees, to which the employer makes contributions for the purpose of distributing corpus or income to such employees, and which trust benefits such employees. A "plan completely lacking in covered employees" obviously does not satisfy these conditions for qualification, said the Service; no more so, a plan completely lacking in an employer.

Of course, a trust without a beneficiary will be struck down as a matter of law for the law abhors a vacuum; whereas private trusts whose grantors are not in existence are commonplace—for example, testamentary trusts created under a will. But the overall purpose of the special tax treatment of employees' trusts would seem to require that an employer-employee relationship obtain throughout the entire existence of the trust in order for the trust to continue to enjoy its special tax advantages.

As long as there is one employee who is actually covered by the plan, the Service concedes that the trust may be qualified, provided that it "is not operated as a means of siphoning profits to a shareholder-employee." The Service has ruled that where a plan was terminated after the cancellation of a war contract, at a time when the only persons covered by the plan were stockholder-employees and a bookkeeper, the plan lost its qualification, retroactively, because it appeared to be a plan to siphon off a substantial portion of the company's wartime profits for subsequent distribution primarily to stockholders. In another case, though, the Tax Court has held that a plan which was terminated at a time when only one employee was covered was not disqualified, since that employee was not a stockholder, officer, supervisor or highly compensated person.

Where the trust is in danger of losing its qualification because of the lack of employees other than those of the favored categories, it does not seem likely that the employer can save the qualification by discontinuing further contributions. The fact that the trust then exists primarily for the favored few is probably enough to disqualify it, though no further contributions are made at that point.

What of the case where the coverage of the plan will not disqualify it, but the employer permanently discontinues the contributions while attempting to keep the trust otherwise in full force and effect? We have already seen that the Service regards the discontinuance of contributions as in effect a termination of a plan without the taking of formal steps. The Code itself says that an employees' trust is qualified if "contributions are made to the trust" by the employer. However, this does not necessarily mean that contributions must be made currently. In *Lincoln Electric*, remember, the employer only made a contribution to the trust once.

The Service has given tacit approval to the permanent discontinuance of contributions to a profit-sharing plan under which the directors had authority to discontinue contributions if they deemed it inadvisable or impossible for the corporation to continue to make them. Other provisions of the plan were to remain in effect and the trust was to be continued in existence. The only requirement imposed by the Service in that case was that all interests of participants vest fully at the time of discontinuance of contributions, lest discrimination become possible in favor of officers and stockholders, etc., who would otherwise stand to benefit from forfeitures of the interests of other participants.

Of course, this apparently liberal position of the Service must be reconciled with its requirement for a permanent plan calling for recurring contributions. I believe that, as long as there have been recurring contributions for a period sufficient to refute any implication that the plan "from its inception was not a bona fide program for the exclusive benefit of employees in general," the discontinuance of contributions will not be prejudicial.

Pensions after mergers

One likely situation in which a company might want to stop contributing to a profit-sharing plan, but otherwise keep

it in full force, is where the company has survived a merger in which one of the constituent companies had a profit plan and the other did not. A termination by the surviving company of the profit-sharing plan and resultant distribution of benefits will not be eligible for the capital gain treatment that is available where distributions are made under a profit-sharing plan in a lump sum in connection with the severance of employment. In such circumstances, the continuation of the trust would spare the beneficiaries any tax until their respective severances from the surviving company.

Of course it is also possible for the surviving company in a merger to keep the plan of its predecessor in force completely intact with full current contributions, by the survivor's simply assuming the predecessor's plan. Requalification of the plan would obviously be advisable under these circumstances.

The real hat trick on a merger involves the transformation of the constituent company's plan into the plan of the surviving company. To make things easy, assume that both companies had pension plans. The transfer of the members' accounts from one plan to the other poses the possibility of constructive realization of benefits, with resultant immediate income tax, while the funds are in transit (if only for a theoretical instant).

This possibility is slight where, under the predecessor's plan, a termination does not entitle the participants to receive an immediate distribution of their vested interests; that is, where the termination by the employer of its obligation to continue to make contributions to the trust does not in any way cause the termination of the trust or the distribution of trust corpus by the trustees. Then the predecessor may terminate its plan, the successor may take over the predecessor's terminated plan, and the participants covered by the predecessor's plan may be given the privilege of joining the successor's plan on condition that they consent to having their accounts under the predecessor's terminated plan transferred to the successor's plan for their benefit. Since the participants would have no right to receive their benefits at such time but only the right to designate that their accounts under the one plan may be transferred to the other plan, no basis for constructive receipt is apparent.

Even where the predecessor's plan calls for distribution of benefits immediately upon termination of the plan, if as a condition precedent to their admittance to the new plan, all participants of the old plan are required to sign an agreement consenting to the transfer to the new plan of all funds to which they are entitled under the old plan, the Service has indicated in a similar situation that taxable income is not realized by the participants.

The more difficult questions arise where the predecessor's plan was a pension plan and the surviving company's plan is a profit-sharing plan, or vice versa. The best thing to do in a case like that might be to keep both plans going for separate groups of employees, or even use both the pension plan and the profit-sharing plan for all employees. However, if it is preferred to put the funds of the profit-sharing plan into the pension plan, you might find helpful a reading of my article on this problem in 10 *Tax Law Review* 531, "Pension After Mergers and Spin-Offs."

Conclusion

With the wealth of materials available today in the official government literature, it is relatively easy to know in advance what kind of plan for deferred compensation can be written to enjoy qualification under the Code. The difficult problems lie outside the plan, when you come to suspending or discontinuing contributions, or when the employer goes out of business or merges with another company. Here there is no certainty. But if certainty means death or taxes, hurrah for uncertainty. ☆

MORE HARM THAN GOOD

A NOT UNCOMMON reaction to a situation in which it is desired to encourage some form of activity is to propose that the income from it be tax-exempt. These proposals often have a considerable emotional appeal, especially if the people to be benefited by them are recognized as being underpaid. But tax exemption does not seem to be the remedy; in fact, tax exemption may do more harm than good even to those who benefit from it. From the standpoint of the tax system itself, and the public respect for it, tax exemptions are bad because they are sure to create resentment on the part of others who regard themselves as more or less similarly situated, but without special tax relief. They are bad because they do in fact reduce the tax base and require higher rates than would otherwise be necessary on income which is still taxable. They may even be bad for those who benefit from them directly, because the exemptions distract attention from the fundamental problem of the level of earnings. When subsequent proposals are made for higher pay scales, a very likely result of tax exemption would be a popular reaction of "But you have tax exemption," even though the monetary advantage of tax exemption would be likely to be much less than the appropriate adjustment in pay. And I note, only in passing, that the advantages of tax exemption may range from substantial amounts for single people down to nothing at all for those with large families. . . . *Dan Throop Smith,* Deputy to the Secretary of the Treasury, at the Tax Institute, Princeton, N. J.

New law gives estate stepped-up basis for unexercised stock option

WITH THE President's signature, H.R. 9035 becomes law, a famous tax trap is removed, and estate planning for the executive holding an unexercised stock option becomes easier. We'll bring you further details on this change and its implications for tax planning when we have had time to study the law in more detail, but briefly, this is what the new law does: it gives a new income tax basis to a restricted stock option exercised by an employee's estate.

Under the old rule, the tax cost of the sale by an employee's estate of the stock acquired under such an option was much higher if the option was exercised by the estate than it would have been had the executive the employee owned the *stock* at the time of his death.

The income tax basis for computing

gain or loss on a subsequent sale was in general the market price at death. A sale after his death produced income tax on only the rise in value occurring after death. But if the employee had not exercised the option during his lifetime and the executor exercised it after his death, the income tax basis for computing gain or loss on a subsequent sale was limited to the option price. In that event, even though an estate tax had been paid on the value of the option, the estate or beneficiaries also had to pay the same capital gains tax as would have been payable had the option been exercised and the stock sold during the course of the employee's lifetime.

While the special two-year and six-months holding periods of the stock option section did not apply to the executor or beneficiary, the general six-months-months-holding-period requirement for obtaining long-term capital gains treatment on a sale of stock did operate, and it did not start to run until the option was exercised by the executor or beneficiary. Thus if the option was not exercised durin gthe employee's lifetime, not only was the capital gain substantial but the executor had to wait six months after exercise before liquidating any of the investment. ☆

New compensation decisions this month

Ordinary income on payment on termination of pension plan. Taxpayer, an employee of a corporation, was a participant in its qualified pension plan. In 1946 the employer-corporation transferred all of its assets to another corporation in a reorganization, and taxpayer then became an employee of the acquiring corporation. Although the latter corporation had its own pension plan, it retained and continued the plan of the acquired corporation for five years, until 1951, when it terminated the plan and made a lump-sum distribution to taxpayer of $20,000. The court holds the distribution in 1951 was not eligible for long-term capital gain because it was not made on account of termination of taxpayer's services to his first employer, but rather on account of termination of the plan. Hence the payment constituted ordinary income. *Buckley,* 29 TC No. 50.

Payments under deferred compensation contract not disability pay. Taxpayer, vice president of Botany Mills, had in 1951 signed an employment contract giving him $35,000 a year until retirement, $25,000 after retirement while he served as consultant and $15,000 if he should be disabled and unable to serve. He became disabled and argues that the $15,000 he received in 1953 should be taxed as health insurance. The court holds this payment could not be considered exempt disability insurance under the 1939 Code. It lacked the characteristics of a plan. In the cases in which uninsured plans were accepted (particularly *Haynes,* 353 U.S. 81), all employees were covered. [Wage continuation payments are specifically exempted under the 1954 Code, with limitations.—*Ed.*] *Kuhn,* DC N. J., 1/3/58.

Suit against employer not necessary for back pay tax relief. Taxpayer was a retired Army officer to whom the Army refused retirement pay because he was a civilian employee of the Federal Government. Another Army officer similarly situated sued and won his retirement pay. The IRS rules that although the Code defines back pay as that in dispute "determined after commencement of court proceedings," the taxpayer need not himself sue for his back pension in order to come within Section 1303. The Code requirement is satisfied by the factually similar case of the other officer. *Rev. Rul.* 58-33.

Lodgings for convenience of employer not tax-free; taxpayer was charged. Taxpayer, a doctor employed by the Veterans Administration, was required to live on the hospital grounds but the fair rental value of the lodgings furnished was deducted from his salary. The court requires the inclusion of the lodgings' value in taxpayer's income. The court holds that the convenience-of-employer exclusion applies only to meals and lodging furnished free of charge. The year involved is 1954 and the new Code governs. Though the Code itself requires merely that accepetance of lodging is a condition of employment, the court finds from the legislative history that those sponsoring the law were thinking only of lodgings furnished without charge. *Boykin,* 29 TC No. 88.

$30,000 to widow of chairman of board was a gift. Taxpayer's deceased husband was chairman of the board of directors of a corporation. Upon his death, the corporation paid taxpayer $30,000 (the amount of her husband's annual salary) over a period of 12 months. They deducted the state gift tax and otherwise treated it as a gift. The court finds that the corporation intended to make a gift rather than pay taxpayer a dividend or additional compensation for her husband's services. The court notes that the majority of the stock of the corporation was held by an estate of which her husband was a beneficiary but that taxpayer was not and that she held only a few shares. *Friedlander,* DC Wis., 10/8/57.

Payments to widow of president found to be compensation. Taxpayer is the widow of the founder and president of a corporation and also the holder of 50% of the stock. The corporation's directors voted to pay her the salary paid her late husband for a 21-month period. The resolution spoke of the payment as recognition of his contributions and also as additional compensation for his services. The corporation deducted the payments as business expenses. Reviewing the cases holding contra and the rulings, the court puts weight on the reference to additional compensation in the resolution and concludes the payments were not gifts but were taxable to the widow as compensation. *Bounds,* DC Md., 12/16/57.

Payments to widow held gifts. Taxpayer's husband and another were co-owners of a two-man corporation. They had an understanding that if one died, the survivor would provide some financial assistance to the other's widow. However, there was no contractually binding agreement to this effect. Payments made by the corporation to the widow, about equal to one year's salary of her husband, are held to be gifts. *Linoff,* DC Minn., 12/30/57.

Informer's award does not qualify as long-term compensation. The tax point here is of minor importance; a taxpayer received an informer's award of $68,800 from the Service and is denied the benefits of 1939 Code Section 107(a) permitting a spreadback of the income; the facts failed to establish that he performed services for the IRS extending over a 36-month period. [See comment on page 234 outlining the story of this inside informer.] *Faul,* 29 TC No. 49.

TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

EDITED BY JOSEPH TRACHTMAN & J. A. MANNING

The short-term trust: a useful device for tax savings in many situations

by **ERNEST WOODWARD II**

Tax planners should keep in mind the tax savings that can be effected by use of a short-term trust in the many situations where its use is practical. The specific statutory rules have brought certainty into an area previously regarded as hazardous. Mr. Woodward briefly reviews some common situations in which such reversionary trusts are useful and warns of the care that should be taken in choosing a trustee and fixing his power.

ORDINARILY, when a gift is made, it must be absolute and irrevocable. But under the 1954 Code, it is possible to give property away with one hand and hold onto it with the other. The feat is possible by means of an irrevocable short-term trust with reversion to the grantor after a term of years.

While, as we shall see, there are many possible variations, fundamentally our fact situation is this: our client transfers income-producing property to a trustee. The terms of the trust direct the trustee to pay the net income to someone else for a period of at least ten years. At the end of that time, the property reverts back to our client.

All the client loses, then, is the use of the property during the term of years. On the other hand, the income during those years will be taxed not to him, but to the beneficiary, who is presumably in a much lower income tax bracket.

Space does not permit us to cover the entire field. But perhaps a few examples of the uses of such trusts will at least stimulate our thinking. In each of these, we should remember that not only income, but also estate and gift taxes may be involved.

Some uses and tax savings

Support of aged and handicapped. Our first taxpayer falls in the bracket between 50-56%. He sends his mother $200 per month for her support, and realizes that he will have to do so as long as she lives. In his bracket, he must earn around $4,000 a year to pay his tax and send this money to his mother.

By creating a trust with assets calculated to produce about $2,500 a year, all of which is payable to his mother, he can do the job better. This sum, less fees, property taxes and incidental expenses will go to his mother and be taxable to her. The "family group" pays about twelve hundred dollars, less tax. We can easily make $2,500 do the job that $4,000 was hard pressed to do before. This trust will continue as long as his mother lives (if it is for life, it doesn't have to last ten years), and then he will get his property back. The value of a gift of income usually runs, roughly, one-third of the total value of the property. If the property is worth, say $75,000, the gift is about $25,000. Against that the annual exclusion is available.

Since the grantor of the trust retains a reversionary interest, the estate tax consequences are insignificant.

We all know people who are supporting aged or disabled dependents. While the saving is more dramatic in the higher brackets, it can be very worthwhile even in a medium bracket.

College fund for young children. These days most parents hope to send their children to college. Costs of a college education are going way up. And when you figure that a taxpayer in the 50% bracket must earn $20,000 in order to have $10,000 left for his son's education, you realize what a tremendous burden it is.

You have a client with a son age eight. For the son, you recommend your client put $25,000 into a ten-year trust. The trust should earn 4%, or $1,000. Of this, the trust uses $600 to pay the premiums on a ten-pay insurance policy on the life of the son, which he owns. Income tax on the undistributed income will be $60, leaving $340 for other uses —I suggest it to pay premiums on a policy on the son which is owned by the *trust*. The son, of course, has no income tax to pay since he has his own $600 exemption. But the father can still claim him as an exemption.

When the boy is 18, the two policies will have a paid-up value of $9,700. This can be used to send him through college. Thus, $10,000 of income has paid only $600 in income tax, and the balance is available for the boy's college education. Of course, if you then have funds available, you can use your own money for his schooling and let him keep $25,000 paid-up life insurance—not a bad start to give an 18-year old in life when you figure that virtually every bit of it was paid out of income tax savings.

And your client gets back the $25,000 he paid into the trust. It's his again, free and clear.

As to the gift tax, the gift will be about $6,000, and the annual exclusion will apply against that. No estate tax consequences, because the trust is taxable in your client's estate because of the reversionary interest.

College or support of older children. A plan similar to this may be used for older children. Suppose your client's son is 18, ready to enter college. Your client puts $60,000 in a ten-year reversionary trust. This is a gift of, roughly, $20,000 and the annual exclusion applies. Income at 4% is $2,000, which taxed to the son after his exemption costs only $312 in income taxes. In your client's bracket, he would have to earn $4,000 to have this much left after he paid his taxes. And since the son is a full-time student, his father can still claim him as an exemption.

Of course, the son's schooling will probably not take ten years. But after he finishes school, he will be needing money to get married, buy a home, buy

furniture, buy a baby—and the money will come better from 20-30% tax dollars than 50% ones.

When the boy is 28, presumably through with his education, married, and beginning to make his own way satisfactorily, the trust terminates and your client gets back his $60,000.

Insurance for others. I have mentioned life insurance several times. Please note that such insurance should be on the life of someone other than the grantor. By express provisions of the Code, if I set up a trust to use the income to pay premiums on policies of insurance on *my* life, such income is taxable to me.

Some authorities believe this may not be exactly true. They say that if there is no obligation on the trustee to so use the income, it can buy such policies as an *investment* of the trust.

In my opinion that's dangerous, certainly until the law is clarified. And until then, the use of the income to pay for insurance on the lives of parents, children or others, gives us sufficient leeway.

Remainder to exempt charity. To this point, we have discussed the short-term trust purely from the view that the creator of such a trust saves no estate tax because he retains a reversionary interest in the property transferred. It may be possible to save some estate taxes by variations of the plans that have been mentioned.

Combine gift with trust

If, for example, you have a well-to-do client who plans to leave a substantial amount to a charity or to his old alma mater, he may combine the gift with a trust. Thus, in our first situation of the dependent parent, if, instead of retaining the reversionary interest in himself, he provides for the payment of the remainder to a university, he could take as a charitable contribution in this year the present value of the remainder interest.

Actually, you can even do this if you keep the income yourself. Yes! Keep it yourself. Here is a widower with an income of $60,000 a year and a good-sized estate. He plans to leave $50,000 to a certain charity in his will. So, you advise him: create a trust this year with a corpus of $10,000, to pay the income to you for life, and then the principal goes to the charity. You get a deduction for the remainder interest, so the cost is (after income taxes) only about $6,000, a saving on income taxes of about $4,000. You do that for each of the next four years.

This means that you do all of these things: First, you give $50,000 to your favorite charity. Second, you save about $20,000 in income taxes. Lastly, you actually increase your income, since you are getting income from the $20,000 that otherwise would have gone out in income taxes.

Obviously, many other variations on this theme are possible. What I want to emphasize is the job that this useful tool can do. I sometimes feel that we do not always realize its potentialities.

Here is possibly a good place for cooperation between accountants and lawyers. Accountants are usually more directly concerned with income taxes, and lawyers with wills and death taxes. Here, we have situations that call for both aspects to be integrated. Both groups should be alert for opportunities, and should explore the problem whenever any possibility of successful use may arise.

Who should be the trustee?

Here let me just simply state that the law spells out in complicated detail certain powers that the creator of the trust may retain without losing his income tax advantage. Personally, I feel we have enough of a "break" without pushing our luck too far. It is legally possible, of course, for the grantor to also be the trustee. Certainly, if you do this, I would not give the trustee any of the Section 674 powers. And I don't like the idea anyway.

This is an emotional and not a legal approach, and I admit it. But we have all seen good ideas fail, and inviting scrutiny of inter-family transactions just doesn't seem a good idea. I cannot point to a section of the Code that says not to do it, but I can show you a lot of situations where otherwise sound plans floundered on too close a personal relationship.

Just as an example, let me point out an unforeseen result of the Uniform Custodian Act. That law is intended to facilitate gifts of stock to minor children by putting the certificate in the name of a custodian.

Recently, a father made a gift to his child and named himself as custodian. The Commissioner had previously ruled that this was a gift of a present interest and qualified for the annual exclusion. But when the father died, the Commissioner held that the stock was nevertheless part of his estate—because as custodian he had the right to withhold enjoyment of the property util the child reached 21. This is expressly made part of his gross estate under Section 2038(a)(i) of the Code.

Similarly, I fear similar results if the grantor of the trust is also the trustee. Emotional the approach may be, but we've seen enough to make us emotional. There are enough other people and trust companies; appoint one of them, relax and feel safe.

Caution as to irrevocability

Having painted, I hope, a pleasant picture of a beautiful land where tax savings grow on trees, we should introduce a note or two of caution.

First of all, to get any benefit, the trusts must be irrevocable. We must not let our clients put themselves in a position where financial reverses or ill-health or the like will hamper them unduly. As in any other instance where a gift is contemplated, we must be absolutely dead sure that our client can afford to make the gift.

Second, this law just came into being in 1954. It is still largely an unknown and untested quantity.

Third, since the trust must be irrevocable, and the tax consequences are purely the result of the statute, we have to recognize that the law could change and leave us (irrevocably) out on a limb. If this happens, however, we would be only in the same position as if we had not tried at all.

For the sake of completeness, one other tax aspect should be mentioned. If the principal of the trust will revert to the grantor, he and not the beneficiary must pay the tax on any capital gains that are realized during the existence of the trust. This does not appear to be much of a problem, however, since they will be taxed at only 25% anyway.

Conclusion

I have obviously hit only the high spots about the short-term reversionary or Clifford-type trust. I have not even mentioned the trust for a charity that

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need run for only two years to get favored treatment. I have not mentioned many other possible uses of the trust schedule. Many of these are most important. For example, the use of a Clifford trust to buy insurance to fund a buy-and-sell agreement, which can give wonderful results. ☆

Tax trap hidden in Sec. 303; careful timing of other redemptions necessary

by **JOSEPH F. GELBAND**

Many owners of family corporations plan to have stock redeemed by the corporation under Section 303 to pay estate taxes and expenses. Not infrequently redemption of additional shares of other heirs is also desirable. The author here points out the existence of the trap (hitherto not suspected by most tax men) resulting from redemption of other stock and suggests that careful timing of the other redemptions may be the way to avoid the tax blow.

DANGER LURKS in a little noticed and less explained section of the regulations relating to redemption of stock of a corporation to pay death taxes and funeral and administration expenses. Section 303 of the Code was enacted to obviate the hardship of a dividend tax on funds sufficient to cover death taxes, etc. withdrawn from a corporation in which a substantial portion of the decedent's assets were tied up. But the relief is circumscribed by subdivision (2)(g) of Regulations Sec. 1.303, which provides: "The total application of Section 303 with respect to stock included in the gross estate of any decedent can never exceed the sum of the amount of the estate, inheritance, legacy, and succession taxes (including any interest collected as part of such taxes) imposed because of the decedent's death and the amount of funeral and administration expenses allowable as deductions to the estate. In determining whether the total distributions in redemption of such stock made within the period of time prescribed in Section 303(b)(1) exceed the amount of such taxes, interest, and expenses, account shall be taken of all such distributions without regard to whether any distribution would be treated as a dividend were it not for Section 303."

The difficulty inheres in the second sentence, in which "all such distributions" are said to count toward the prescribed monetary limit. There are dangers hidden in this somewhat ambiguous but far from innocuous sentence.

The point may be illustrated by the ideally simplified example of an estate which owns 1,000 shares of stock of a corporation, constituting at least 35% of the gross estate. The decedent left a son and a daughter, neither of whom owns any stock in the corporation, as his only heirs. Under the will, 500 shares are specifically bequeathed to his daughter, and the balance, as part of the residuary estate, to his son. Of the balance, 300 shares are intended to be redeemed, at estate tax valuation, to defray the Section 303 expenses.

It is decided (either in pursuance of a direction in the will, or because the stock is unattractive as an investment) to have the corporation redeem all of the stock bequeathed to the daughter, at estate tax value, and to reinvest the proceeds more suitably. Accordingly, 500 shares of the stock held by the estate are transferred to the daughter against her complete release to the executor, thereby, it may be assumed, terminating the daughter's interest in the estate. Shortly thereafter the corporation redeems for cash the 500 shares held by the daughter. Attributability to the daughter of stock held by the estate having thus been avoided, the distribution by the corporation is, under Section 302 (b)(3), treated as a distribution in exchange for the stock, at least to the extent the redemption price does not exceed the then fair market value of the stock. But the death taxes, administration and funeral expenses(chargeable in our case by reason of state law, a direction in the will, or by arrangement of the heirs themselves, solely to the son's interest in the estate) have not yet been paid, and a Section 303 redemption of 300 shares of the stock retained by the estate seems to be the appropriate source of funds. But under Regulations Sec. 1.303(2)(g), no redemption at this juncture could qualify as a capital transaction under Section 303! Indeed, a redemption might well result in treatment of the distribution as a taxable dividend to the estate.

Any preliminary doubt as to the intendment of the foregoing regulation, arising from the Treasury's liberal use of the word "such," may be resolved by consideration of the language itself. The phrases "such stock" and "such taxes, interest and expenses," both in the second sentence, of course allude respectively to their obvious antecedents in the first sentence. It is submitted that the phrase "all such distributions" can, in context, refer only to all distributions in redemption of stock included in the gross estate, whether made under the aegis of Section 302, 303, or otherwise. A variant construction would render the sentence a virtual tautology—it would say in effect "In determining whether the *total* distributions made pursuant to Section 303 are in excess of the amount allowable thereunder, *all* distributions pursuant to Section 303 shall be taken into account."

The first sentence, incidentally, seems to leave no room for doubt that redemption of stock merely attributable to the estate, but not included in the gross estate for estate tax purposes, does not count toward the maximum allowance under Section 303.

Had the persons in our example been aware of this pitfall, they might have accomplished their purpose by permitting no redemption of the estate's stock, except for Section 303 purposes, to be had during the period limited by Section 303 (three years and 90 days from the date of filing the estate tax return), deferring the redemption of the daughter's stock pending the elapse of this period.

There remain at least two unanswered questions:

Does a partial redemption, the proceeds of which are taxable as a dividend, count toward the total? Although in the crucial phrase "such distributions" the adjective "such" appears to restrict "dis-

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tributions in redemption," certainty that the Treasury intends thereby redemptions treated as such for tax purposes, would be desirable, however grotesque the opposite interpretation might be.

Suppose, in our example, the executor had the necessary 300 shares redeemed pursuant to Section 303 prior to his turning over the 500 shares to the daughter. Then, within the period limited by Section 303, the daughter, having received all she was entitled to from the estate, and her interest therein having been severed, proceeded with a complete redemption of her 500 shares. Does this latter redemption divest the earlier redemption, on account of Section 303 expenses, of the favorable treatment seemingly accorded by that provision? The writer, although cognizant of the possible curtailment of income to be incurred by waiting, suggests that unless a favorable ruling can be obtained in the circumstances, the only safe course is to await the expiration of the Section 303 period. ☆

New estate & gift decisions this month

Decendent's will gave community property to son; widow's acquiescence a gift. Under her husband's will, taxpayer was given a $35,000 bequest plus a life interest in the residue. However, the husband treated community property as his own and includible in this residue. When taxpayer elected to take under the will rather than to take her share of the community property, the Tax Court held, she made a gift to her son, the remainderman of the trust. The gift was equal to the value of her share of the community property less the value of all interests in both her and her husband's shares which she retained under the will. This court affirms. *Siegel,* CA-9, 11/6/57.

Trusts for minors not present interest; trustee could determine need for income. Taxpayer created five trusts in 1951. His four adult children were income beneficiaries of four of such trusts. Their right to income, being a present interest, qualified for the $3,000 annual exclusion. However, the IRS argued that because the trustee had power to invade principal for them, it was not possible to compute that income to value the interest given. The court holds, however, that this power was limited by ascertainable standards, and the standards imposed and the donees' large fortunes outside this trust made the possibility of encroachment so remote as to be negligible. The fifth trust was for the benefit of four minor grandchildren, each of whom was to receive so much of the income from and the principal of his separate share as the trustees might deem necessary for his support, maintenance and education; this, until the respective beneficiaries reached the age of 21, at which time the income was payable directly until termination. Here no standards were provided and the courts hold that the right to receive such unascertained distributions as a trustee may determine constitutes a future interest, and consequently no exclusion is allowable. *Jones* 29 TC No. 25, 11/13/57.

Previously taxed property is net of taxes paid by recipient [*Acquiescence*]. As joint tenant, decedent succeeded to property included in his wife's gross estate. Under applicable New York law he became liable for the estate taxes attributable to this property. He never paid the tax, but it was a debt of his estate to hers. The court holds that in computing the deduction for property previously taxed, the amount of estate tax payable on this property must be deducted from the value of the property as representing the net amount transferred to this decedent. [The 1954 Code replaces the deduction for property previously taxed with a credit, but the principle of this decision is applicable—*Ed.*] *Osborn Estate,* 27 TC 82, *acq.* IRB 1957-41.

Gift incomplete; power retained to invade for comfort [*Nonacquiescence*]. Taxpayer created a trust of her securities for the purpose of providing satisfactory management of the trust property. The income was to be payable to her for life, and the trustee had power to invade principle to provide for her comfort and well-being. Because of the virtually unrestricted power to invade the corpus for her benefit, the court holds that the taxpayer had not made a completed gift. A spendthrift provision in the trust does not lessen her control because such a provision is not effective to protect a settlor's interest from the claims of creditors under governing Michigan law. *Vander Weele,* 27 TC 340, *nonacq.* IRB 1957-41.

Reliance upon attorney sufficient cause for failure to file return. Decedent determined to transfer the major portion of her holdings in the stock of a family corporation to a trust. A person of very limited education, she sought advice from her investment counselor, who recommended an attorney. The attorney was employed to do the legal work and, specifically, to consider the tax problems involved in the transfer which, it was intended, would not be initially subject to tax. The trust was established in 1944, and further transfers made in 1945, as the attorney knew. No gift tax return was filed until after decedent's death in 1952. No penalties may attach to the 1944 and 1945 taxes by reason of the failure to file returns within the prescribed period, since decedent's reliance upon her attorney constituted, under the circumstances, reasonable cause for such failure. *Baer Estate,* TCM, 1957-211, 11/7/57.

No gift; trust might be invaded for donor-beneficiary [*Nonacquiescence*]. Taxpayer created a trust of which she was the only income beneficiary during her lifetime and the trustee had the power to invade principal for her maintenance and comfort. The Tax Court held that there was no gift tax on the transfer in trust; the principal might be completely depleted for the donor's benefit. *Gramm Estate,* 17 TC 1063, *nonacq.* IRB 1957-49.

Reserved life income, payable at trustee's discretion, reduces taxable gift. [*Nonacquiescence*]. For gift tax valuation, there must be excluded the life interest reserved by the donor. The trustee was to pay income to the donor at his discretion, and the court finds, under these circumstances Massachusetts law gives creditors full recourse to trust income. *Alice Spaulding Paolozzi,* 23 182, *nonacq.* IRB 1957-49.

Gift taxable on transfer of property to guardian [*Acquiescence*]. The Tax Court held that, under California law,

Notes on new estate and gift decisions in this department are by Edward P. Hannigan, member of the New Jersey Bar and associated with Harrison F. Durand in Newark.

neither an oral transfer of securities in 1943 or a subsequent written one were irrevocable. No gift tax was due, therefore, until 1946 when, after the death of the trustee, the securities were transferred to a guardian for the beneficiary. *Newman,* 19 TC 708, *acq.* IRB 1957-38.

Joint property transfer "in contemplation"; half taxed [*Acquiescence*]. Decedent and his wife made a transfer in trust of stock and securities owned by them as tenants by the entireties. The Tax Court concluded that the transfer was made in contemplation of death. But since the property transferred was held under a tenancy by the entireties, only one-half of the value so transferred in trust was included in decedent's gross estate. *Borner Estate,* 25 TC 584, *acq.* IRB 1957-41.

Wife is possible beneficiary of husband's gift; can't report it as split. Taxpayer created a trust in which his wife had an interest in the income, the remainder to others. The trustees had the power to invade the corpus for the benefit of the wife, if in the trustee's judgment it was necessary for her welfare. Although taxpayer showed that his wife had property of $132,000 of securities, he did not show, the court finds, that an invasion of the corpus would be improbable. The Code permits husband and wife to treat a gift by one as a gift by both only if it is to a third party. Because of the wife's interest in the remainder, its value cannot be treated as a split gift. *Kass,* TCM 1957-227.

Grantor taxable on trust income used to pay gift tax. A grantor made a gift of stock in trust for the benefit of a nephew. The trust instrument provided that the trustees were to pay any gift tax assessed with funds to be borrowed from a bank, the trusteed stock serving as collateral. The Service holds that the income of the trust is taxable to the grantor, since it is to be used to discharge his legal obligation to pay the gift tax. *Rev. Rul.* 57-564.

Indirect payment of premiums results in inclusion of life insurance proceeds (Old Law). Decedent had assigned a life insurance policy to his wife seven years prior to his death, and his wife had, after that time, paid the premiums with checks drawn on her own account. The testimony of the wife was insufficient, the court concludes, to support the executors' contention that the premiums had not been paid with funds indirectly derived from the decedent, and the value of the proceeds of the policy are held includible in the decedent's gross estate. *Wolf Estate,* 29 TC No. 48, 12/12/57.

Claims barred by statute of limitations not deductible from estate. Decedent had borrowed sums from his wife and four children, giving promissory (demand) notes in return. The statute of limitations had barred collection of the sums owed by the wife and two of the children, and consequently, the court holds, no deduction could be had from the gross estate on their account. The claims of the two younger children, however, were based upon valid, subsisting debts, and were deductible as claims against the estate. *Wolf Estate,* 29 TC No. 48, 12/12/57.

Local law limitation on power of appointment costs estate marital deduction. Decedent left one half of his estate in trust to pay the income to his wife for life, and upon her death to pay the principal to those designated in her will. There was a named taker in default. Under the governing state law, such a testamentary power did not permit the donee to appoint to her own estate or its creditors. Since local law determined the extent of her interest, and she had no power herself to consume corpus, this limitation upon the extent of her power of disposition deprives the decedent's estate of the marital deduction. *Allen Estate,* 29 TC No. 52, 12/19/57.

Retention of secondary life estate not taxable under joint resolution of 1931 (Old Law). It was conceded that decedent should be considered the grantor of a trust which paid another an annuity, with the decedent receiving any excess income during the life of the annuitant (and, after the annuitant's death, all of the income). There were remaindermen named. The annuitant survived the decedent. The Commissioner contends that the value of the trust estate is includible in decedent's gross estate as a transfer with a retained income interest. The court concludes that it is not. The decedent's interest in excess income during the annuitant's life was without value, as there was no excess. Since the transfer was made on January 26, 1932, the amendment to the Joint Resolution of 1931 enacted later that year, which for the first time taxed transfers under which the transferor had retained the income from a trust "for any period not ascertainable without reference to his death," was not applicable. It was the addition of the quoted phase which extended the coverage of the statute to include transfers under which the transferor has retained a secondary life estate which had not vested prior to the transferor's death. The law in effect in 1932 did not require the inclusion of such transfers. *Hubbard Estate (Merchants Nat'l Bank of Mobile, Ex'r),* CA-5, 12/6/57.

Contingent power never became operative; trust assets not includible. Decedent, a nonresident alien, created a trust in 1903 under which she retained the income for life. Upon her death, the corpus was to go to her issue, but if there were more than one such issue, or if there were none, she retained the power to allocate the shares of the trust estate by will. She was survived by a son, who was childless. Since the condition pursuant to which her testamentary power was to become operative never occurred, she did not at the time of her death, the court holds, possess the power to alter, amend or revoke the transfer, and consequently, the trust corpus is not includible in her gross estate. Trust income, which the decedent had permitted to accumulate with the trustee bank, was money on deposit for a nonresident not doing business in the United States and, by specific provision of the Code, subject to the estate tax. *Brooke Trust (Bank of New York Tr.),* DC N. Y., 11/26/57.

New trusts & estates decisions

Trusts were sham; income taxed to grantor [*Certiorari denied*]. Taxpayer alleged that he had formed three trusts for the benefit of his wife and two sons, and had given each trust a $10,000 interest in a partnership in which he was associated. On the facts the Tax Court found that the arrangement was a sham and that the amounts allegedly receivable by the trusts were income from the partnership due and payable to the taxpayer. The Eighth Circuit affirmed.

Taxpayer retained complete control over the trust corpus in naming himself and his brother-in-law trustees and in requiring the trust corpus to remain in a partnership he controlled. *Paster, cert. den.* 11/18/57.

Grantor taxable on trust income used to satisfy his gift tax. An individual made a gift of all of his stock in a corporation in trust for the benefit of his nephew, conditioned on the trustee's assumption and agreement to pay gift taxes on such transfer with borrowed funds. Since the gift tax liability is a liability of the donor, the Service holds any trust income applied in satisfying the obligation to pay the gift tax will be taxable to the donor thereof. *Rev. Rul.* 57-564.

Grantor taxed on trust income to extent of retained charge. In 1948, taxpayer and her husband purchased business real estate for about $360,000. Some two months later each created a trust for their son to which each transferred his undivided half interest, worth about $180,000, subject to a charge reserved of $150,000. Taxpayer and her husband secured this equitable charge with a lien, but the trust instrument provided there could be no foreclosure. They, as trustees, had the power to prepay the charge. The district court held that each taxpayer is taxable on 83⅓% (150/180) of the income of the trust. This court affirms. To the extent of the charge the taxpayers, in effect, retained a right to revest the corpus in themselves.. *Barber,* CA-5, 1/14/58.

Revocable trust has stepped-up basis on death of settlor. The settlor of taxpayer-trust retained a power to revoke the trust; therefore, when settlor died in 1945, the trust was included in his gross estate. The trust shortly thereafter made a taxable exchange of some stock. The court holds that the basis of the stock which it received from the settlor in 1931 was the fair market value at settlor's death. *Kirby Trust (Bankers Trust Co., Tr.),* Ct. Cls., 12/4/57.

Beneficiary cannot deduct interest paid on trust's tax deficiency. Taxpayer was both the income beneficiary and remainderman of a trust. After corpus had been distributed to him, an income tax deficiency was assessed against the trust. He paid the deficiency and interest and now seeks to deduct the interest. The Commissioner allowed the interest that accrued after the taxpayer received the corpus, but disallowed the interest that accrued before then. This court agrees with the Commissioner. Until the corpus distribution, taxpayer had no liability for the tax; not being the debtor, he cannot deduct the interest. Nor can he be allowed the interest as a nonbusiness expense; for the conservation of income producing properties this interest is not an expense but a charge against corpus. *Norton,* CA-5, 1/9/58.

Trust did not terminate until distribution date; losses were incurred by trust, not beneficiaries. Taxpayers were remainder beneficiaries of a trust. By its terms, the corpus was to be distributed ten years after the death of the life beneficiary. Because of the filing of the trustees' accounting, the actual distribution did not take place until three months later. Applicable Pennsylvania law indicates the trust is considered to continue during this period. Thus, net operating and capital losses incurred by the trustees during the interim period are losses of the trust and cannot be claimed by the beneficiaries. [1954 Code Section 642(h) permits the beneficiaries to succeed to unused loss carryovers of a trust.—Ed.] *Swoboda,* DC Pa., 11/13/57.

No estate tax basis for trust so taxed; 1954 rule applies to specific trusts only. In 1930, the chief executive and majority stockholder of a corporation created a trust of certain shares of the stock of the corporation. Upon his death in 1945, the trust was included in his gross estate because he retained certain interests in it. In 1955, the corporation was liquidated and the trustees ask for a ruling on the basis of the shares in the trust. The IRS holds that the inclusion in the grantor's estate does not affect the basis, which is determined by the rules applicable to gifts. The 1954 Code provision allowing a basis equal to value at date of death for certain trust assets included in the donor's taxable estate does not apply here. That rule applies only to trusts includible because the grantor reserved income or rights to amend. This grantor had no such powers. *Rev. Rul.* 57-543.

Income in respect of a decedent treated as corpus to distributee [*Acquiescence*]. Taxpayer's husband's will provided that his residuary estate be set up in trust for her benefit. Rentals accrued but unpaid at the date of death were included as an asset of his estate. The court held that the rentals, when collected, although includible in the trust's gross income as "income in respect of a decedent," are not to be included in the gross income of the wife as a distribution of income. The court follows its own decision in *Huesman,* 16 TC 656, *affirmed on other grounds,* 198 F.2d 133, that Section 126 makes no provision for taxing income in respect of a decedent to anyone but the recipient (here the trust). The court also holds that $5,000 withheld from distribution by the trustees as a "reserve for repairs," and $2,000 withheld as a "reserve for trustees' commissions" as determined by a state court, properly withheld and being unavailable to taxpayer, are not distributable income and accordingly should not be included in her income. *Carruth Estate,* 28 TC 871, *acq.* IRB 1957-47.

Royalties paid to author's heir is "income in respect of decedent." Royalty payments being received by taxpayer under a contract executed by her late father, an author, and extended by her deceased mother as executrix of the father's estate, is taxable to the daughter as income in respect of a decedent. *Rev. Rul.* 57-544

Treaty exempts trust corpus capital gain; all beneficiaries are U. K. residents. The district court held that taxpayer, a U. S. trustee, must pay a tax on capital gains realized by the trust and allocated to corpus even though all life beneficiaries and remaindermen are residents of the U. K. Though the treaty between the U. S. and the U. K. exempts residents of the latter country from U. S. capital gains tax, the lower court held it not applicable since the taxpayer is the trustee and it is not a U. K. resident. This court reverses. It finds the intent of the treaty was to exempt nonresident beneficiaries and that it should construe the language broadly. Therefore, even though the gain is not currently distributable, it should be exempt. *American Trust Co.,* CA-9, 7/8/57.

Half-brother and sister covered by trust relative rules. The term brother and sister as used in Section 672(c) which defines parties related to the grantor of a trust in cases where the grantor or other parties are treated as the substantial owners, include a brother and sister by the half-blood. *Rev. Rul.* 58-19.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

How tax treaties benefit U. S. companies doing business abroad

by **MITCHELL B. CARROLL**

On all questions of tax on Americans or American business abroad, you not only must check the U. S. law and the law of the foreign country, but also must consider the tax conventions, if any, between the U. S. and that country. Mr. Carroll analyzes briefly the tax reduction rules found in our fundamentally quite similar conventions with leading commercial countries and concludes they offer substantial incentives to any business considering expansion abroad.

AN ARTICLE IN a recent issue of a foreign trade weekly stated in substance that conventions for the avoidance of international double taxation were intended to benefit the respective governments rather than to help the taxpayers concerned. As I see it, their primary purpose is to aid the enterprises of one country to invest or carry on business in the other contracting party, and this is especially true in conventions negotiated by the United States.

The United States now has in force income tax conventions with 21 foreign countries. The U. S. also has had in mind the heirs of Americans who go abroad to live and acquire investments overseas to live and acquire investments ernment has concluded 12 conventions to avoid the double imposition of taxes on estates or inheritances. However, I am here concerned only with income tax conventions.

In order to understand the benefit of income tax conventions, let us suppose that someone who is in charge of developing the foreign commerce of a domestic corporation is looking into the advantages or disadvantages of selling goods through intermediates abroad or establishing a branch or a subsidiary in one or more foreign countries, and incidentally sending there its sales representatives or technicians.

In the first place, if there is in force a tax treaty with the foreign country, the corporation executive will, perhaps with the aid of his lawyer, look at the taxes imposed by the foreign country and then check the treaty to find to what extent they have been modified in his favor by the terms of the convention.

No tax on direct sales

If the executive intends to export goods on the basis of orders received from an intermediary in the foreign country, he can escape taxation there if the intermediary qualifies as a bona fide commission agent, or broker or agent in the exception to the concept of a permanent establishment as defined in the convention. Likewise, he will see that under the same definition his firm will not be taxable if the orders are merely solicited by travelling salesmen or by mail.

Taxation of a sales branch

If the executive decides to establish a sales office in the foreign country, he will find that while he will have a permanent establishment in the foreign country, he will be taxable only on the basis of the net profit attributable to selling in the foreign country and not on the part of the profit that should be ascribed to the manufacturing of the goods in the United States. This, of course, presupposes an appropriate invoicing of the goods to the branch on terms that would prevail between independent parties. Furthermore, under numerous conventions, he will be able to deduct in determining the net income taxable in the other country a reasonable proportion of the U. S. head office general and administrative expense.

If a foreign subsidiary is created, the American executive will be pleased to find in the treaty that it will be taxable as an independent entity, and this presupposes invoicing on an arm's length basis.

Dividends

Dividends received from the subsidiary will, according to the terms of the particular convention, be specifically freed from any withheld tax in the Netherlands and Japan, or be subject, presupposing the parent holds a prescribed percentage of the subsidiary's voting stock, to a reduced rate of only 5%, in Austria, Canada, Denmark, Finland, Italy, and Switzerland. In Sweden the limit of the tax at source is 10%; in Australia, France and Germany 15%. In general, the object of the rate reduction is to bring the total effective rate of the taxes on the foreign subsidiary and the dividend which it distributes down to or below the U. S. rate of 52%. In the United Kingdom and Ireland, the U. S. corporation is assured of the foreign tax credit for the standard rate of tax of those countries which is imposed upon the foreign subsidiary, regardless of the amount of voting stock held in the foreign corporation. In Japan, credit can be taken for the company tax to the extent of 25%, if the recipient grosses up the dividend by the amount of said percentage.

In this way the domestic corporation receiving dividends from a foreign subsidiary should not in general have to bear a heavier burden than it does at home.

Interest

If the American parent corporation provides working capital to the foreign subsidiary by way of loans, under numerous conventions no tax will be imposed at source and the interest received is included in the gross income of the recipient from which all its expenses are deductible. The U. S. creditor can receive what is considered an appropriate rate of interest without any reduction

by virtue of a withholding tax, and the borrower is not faced with the possibility of having to assume the tax. Such exemption at source is assured under conventions with Austria, Denmark, Finland, Germany, Honduras, and Norway. Some conventions apply restrictions. Those with Greece, Ireland, the Netherlands and the United Kingdom exclude loans to a more than 50%-owned debtor corporation.

In some treaties the source rate on interest may not exceed a certain percentage, such as 15% in Belgium, Canada, France, and Japan, and in Switzerland the ceiling is 5%.

Royalties

In order to encourage American corporations to supply "know-how" and the like to their subsidiaries or other companies in their territories, numerous countries agree to exempt at source royalties paid for the use of patents, designs, secret processes and formulae, trademarks and similar rights or property. This has the advantage of freeing the royalties from a source tax on gross income so that they will be subject to the U. S. tax on net income after deduction of expenses. Such is the case under conventions with Austria, Belgium, Denmark, France, Germany, Greece, Honduras, Ireland, Italy, the Netherlands, Norway, Pakistan, Sweden, Switzerland, and the United Kingdom. Japan limits the source tax to 15%.

When the head of the export department wants to go abroad himself, he will be happy to find that under most of the conventions he will not be taxable in any country in his itinerary which has a tax treaty with the U. S. if his stay there does not exceed, in general, 183 days in the taxable year.

Conclusion

Such are the general advantages of the income tax conventions. There are a number that contain special provisions which overcome peculiar features of the foreign tax laws. Moreover, if cases of double taxation arise which are not covered particularly by the convention, provision is made for calling upon the tax officials of the two countries to settle them.

In order to assure relief from double taxation, such as where tax is paid in the other country directly on the branch income, or by withholding from the dividends, interest, or royalties, credit is allowed against the U. S. tax as is provided in Sections 901-905 of the Code. Hence, amendments to the credit provision, such as one to allow an election for the formerly provided overall limitation, or the carryback and carryforward of excess foreign taxes over the allowed credit, would supplement the benefits under tax treaties.

Until now, treaties have not provided for a reduction in the U. S. tax on profits to the level in the other country, but the enactment of the proposed 14-percentage-point reduction would, of course, benefit also U. S. corporations operating in treaty countries. [Provisions which would have reduced the U. S. tax on foreign-source income by 14 percentage points were proposed for inclusion in the 1954 Code but failed of passage.—*Ed.*] It would be helpful if the administration could introduce such a rate reduction in treaties.

You have all heard of the administration's proposal to amend the credit provisions by treaty to cover taxes "spared" by foreign governments to attract investments, which is provided in the proposed treaty with Pakistan.

Another provision, one I would like to see included in treaties, would be a clause to treat the United States citizen employed by a branch or subsidiary abroad (and therefore a bona fide resident in the foreign country) as if he were a resident native employee and grant him the same exemption on income earned while in the U. S. on business as his alien colleagues are privileged to enjoy.

Tax treaties could be improved, but they are definitely beneficial to the American corporation that operates or invests abroad, and its employees. The National Foreign Trade Convention urges the State and Treasury Departments to hasten the conclusion of those pending with Cuba, Columbia, Mexico, Peru and the Philippines, and to enter into the negotiation of conventions with the numerous other countries in which American corporations have interests. It is to be hoped that the suggested improvements might be incorporated therein. ☆

[*Mitchell B. Carroll is a member of the New York Bar, is President of the International Fiscal Association, and serves as a Special Counsel to the National Foreign Trade Council Tax Committee. This article is based on a speech presented before the N.F.T.C. Tax Session last November.*].

TAX GOAL

I BELIEVE, first, that the United States should follow England's lead and permit U. S. taxes on foreign income to be deferred until the income is returned to the U. S. I believe that such a deferral makes good business sense, and should not be limited only to those foreign businesses which the administration wishes to encourage; it should be over-all. . . .

Secondly, I believe that the U. S. tax rates on foreign incomes should be lowered. This would put U. S. business operating abroad into a more equal competitive position with foreign business.—*R. R. Jorgensen,* Head, Tax Department, Sears, Roebuck & Company, at the 13th National Tax Conference of the Tax Foundation.

English Inland Revenue convicts 57 out of 59

THE ONE HUNDREDTH annual report of the English Board of Internal Revenue reveals that in the year 1956-57 there were 59 criminal prosecutions undertaken, resulting in 57 convictions. One of the two nonconvictions arose from a plea of nolle prosequi on grounds of ill health! ☆

New decisions

State S&L certificate holder a "depositor"; withholding on alien not required. The Code requires withholding of fixed and determinable income payments to nonresident aliens but grants an exception for interest on deposits with banks. The IRS has previously ruled (*Rev. Rul.* 54-624) that so-called interest on Federal Savings and Loans accounts is in fact a dividend and that withholding is required on their payments. The IRS here considers the status of state-chartered Savings and Loan Associations and, noting that their investment certificate holders have no voting rights and stand in all essential respects in the relation of debtor and creditor with the association, concludes that payments to them are interest and that withholding on payments to nonresident alien certificate holders is not required. *Rev. Rul.* 58-34.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Public accountants ask for limited Treasury practice without qualifying examination

NONCERTIFIED public accountants have been endeavoring to obtain a limited admission to practice before the Treasury Department which would enable them to represent clients up through the group-chief level without having to take a qualifying examination. At the present time, persons who are neither lawyers nor certified accountants can obtain the regular Treasury card by passing a qualifying examination. The examination used has been the problems section of the regular nationwide uniform CPA examination used by all the states.

Leading the public accountants in their endeavor to remove the hurdle of this quite difficult examination has been the National Society of Public Accountants. Their Committee on National Affairs met with Treasury officials in April of last year, and the IRS requested that they make a proposal designed to accomplish their objectives. The committee now makes public their proposals and the results of a questionnaire to their members about their education, experience and the amount of tax work they do.

NSPA memorandum

"We have long been of the belief," said NSPA, "that by reason of the broad scope of their work, by reason of their education, experience, and technical competence, our members, now numbering more than 7,500 persons, could form a guide for use in the promulgation of regulations to bring about . . . [our] . . . objective. Accordingly, we prepared and mailed a questionnaire to all of our members in order to obtain information. The questionnaire is set out in the adjoining box.

"Now that the results of the questionnaire[1] have been tabulated and studied, we submit that a fair interpretation thereof demonstrates that our members, in experience, scope of work, education, and technical competence, are as well qualified as former Internal Revenue employees who, under certain prescribed conditions set out in Treasury Department Circular No. 230, now are granted a Treasury card without examination. Why, then, with the results of our questionnaire as a basis, could not the Treasury Department promulgate regulations similar to those now in effect with respect to former internal revenue employees,* so that a noncertified, practicing accountant could, without examination, obtain a Treasury card that would permit him to represent his clients through the group-chief level of the Service?

Hoover Commission proposal

"To enable the noncertified accountant to represent his clients through the group-chief level would be in harmony with the recommendation made in a Report to Congress by the Commission on Organization of the Executive Branch of the Government, under the chairmanship of former President Herbert Hoover, in March, 1955. It was there stated:

Such cards [Treasury] are issued to lawyers and to Certified Public Accountants, subject only to character investigation. Other persons, including public accountants generally, must pass an examination given by the Treasury Department. *Public accountants should be permitted, without examination, to deal with tax returns prepared by them through the group-supervisor level of the Internal Revenue Service. . . .* (Italics supplied by NSPA).

"The foregoing recommendation was based on the Commission's Task Force Report on Legal Services and Procedure. It was there stated:

Only persons who hold cards issued by the Treasury Department may engage in negotiations on behalf of taxpayers with the Internal Revenue Service. Such cards are issued to lawyers and to Certified Public Accountants, subject only to character investigation. Other persons, including public accountants generally, must pass an examination given by the Treasury Department. *In the opinion of the task force, public accountants should be permitted, without examination, to defend tax returns prepared by them through the group-supervisor level of the Internal Revenue Service. . . .* (Italics supplied by NSPA).

"More recently, on April 22, 1957, a Progress Report of the Subcommittee on Internal Revenue Taxation to the Committee on Ways and Means (the so-called Mills Report) took further recognition of the need for noncertified, practicing accountants to represent their clients through the group-chief level.

"If proof is desired" continued NSPA, "with respect to the importance of the work of the noncertified, practicing accountant to the collection of Federal revenue, one need only to consider some of the statistics obtained from the questionnaire mailed to our members.

"More than 3,000 answers were received in response to the majority of the fifteen questions on the questionnaire. Based on the answers received, we have learned that the average age of our members is 49.8 years, and that almost 95% are married with 1.4 dependent children. These particular statistics are important in that they denote men of maturity and responsibility.

"Our members are, generally, proprietors of their own accounting prac-

* [Part 12 of Circular 230 provides that "In examining the qualifications of an applicant for special enrollment on account of Treasury service, the committee will be governed by the following policies: (1) Special enrollment cards will be issued for the presentation of matters only of the particular class or only before the particular bureau, unit, or division of the Treasury Department for which his former Treasury service has qualified the applicant. (2) In the case of employees separated from employment in the Treasury Department, application for special enrollment on account of such employment must be made within two years after the termination thereof . . . ."—Ed.]

[1] When the questionnaire was mailed, in early May, 1957, the membership totaled 7,350. Since then, it has increased to more than 7,500 members. Some of the answers tabulated show a projection of the figures based on 21,537 prospects as future members. These prospective members are persons now engaged in the practice of accounting, whose qualifications meet the membership requirements of the by-laws of the NSPA.

[2] Form 1040A 11,187,325
Form 1040:
Short-form 23,668,350
Long-form 22,982,509

[3] Returns on Form 1040A are not included.

[4] This includes fiscal year returns ending in July through November of 1953 and January through June of 1954

tice. This is evidenced by the fact that, as an average per member, they have been in practice as a principal for 12.9 years. (Question 4) When to this figure is added the number of average years per member that they have been an accountant, other than as a principal, namely, 9.1 years, (Question 5) it adds up to practical experience of 22 years in their profession.

"Our average member is a force in the labor market by reason of the fact that, not including himself, he employs 2.5 persons. (Question 6) When this number is multiplied by our total membership of 7,500, we find that a total of 18,750 persons are employed. If we add the 7,500 members to this number, the members of our organization alone are providing gainful employment for 26,250 persons in the labor market.

"Important though the foregoing statistics are, in that they tell much about some of the general characteristics of our members, it is when we consider the substantial assistance rendered by our members to the Federal Government in its collection of billions of dollars in revenue that the true significance and importance of the noncertified, practicing accountant is understood best.

Filing form 1040

"Statistics of Income for 1953, Part I, which is the latest complete report, having been published in 1957, discloses that 57.8 million individual income tax returns were filed for the 1953 income year.[2] Included in that year are returns for the calendar year 1953, a fiscal year ending within the period July, 1953, through June, 1954, and a part year with the greater number of months falling in 1953.

"Answers to question 9 reveal that, as an average per member, our members (comprising self and 2.5 employees) prepared 2,242,485 returns on Form 1040.[3] In other words, our members prepared approximately one out of every 23 Form 1040s that were filed for 1953. Percentagewise, that means almost 5% of the total number.

"How significant, in terms of revenue dollars to the Federal Government, is the fact that our organization prepared almost 5% of all 1040 forms filed for 1953 income? The answer is found in Statistics of Income for 1953, Part I. Of the 45.2 million taxable individual income tax returns filed, the average income tax liability amounted to $666. When we consider that our group prepared over two million returns, (2,242,485) we determine that the individual returns they prepared brought in approximately 1.5 billion dollars to the Federal Government. This is substantial portion of the total individual income tax liability of 29.4 billion for 1953. While it is true that, in 1953, some members filed returns that are included in the 12.6 million nontaxable individual returns, we believe that this is offset by the fact that the 2,242,485 figure used does not include Form 1040A, and the latter is included in the 45.2 million taxable individual returns.

Filing form 1041

"The impact of the noncertified, practicing accountant on the revenue derived by the Federal Government from the tax on fiduciary income cannot be measured, because returns for fiduciary income for 1953 were not processed by the Statistics Division of the Internal Revenue Service; therefore, no information regarding income of estates and trusts is included in that report.

"From the almost 3,000 answers received to question 12, relating to the number of Form 1041s prepared by our members, we find that, as an average per member, 6.7 returns were prepared. When this is extended to include our total membership, it appears that 49,245 Form 1041s were prepared. That is 4,550 more than all gift tax returns filed for gifts made in 1953, and 11,573 more than all estate tax returns filed during the calendar year 1954.

Filing form 1120

"Our members prepare a substantial number of income tax returns for corporate clients. Based on the number prepared, as an average per member, namely, 14.1, which is most certainly on the

NSPA QUESTIONNAIRE TO MEMBERS

1. Your age . . . . . 2. Married . . . Yes..... No.....
3. Number of dependent children . . . .
4. Number of years in public practice as a principal .....
5. Number of years employed as an accountant other than as a principal . . . .
6. How many employees in your organization not counting yourself? . . . .
7. Education:
   a) High school graduate . . . . . Yes..... No.....
   b) Did you attend college? . . . . . Yes..... No.....
   c) Name of college .....
   d) Number of years attended . . . .
   e) Did you graduate? . . . . . Yes..... No.....
   f) Did you you take any correspondence courses? . . . . . Yes..... No.....
   g) Courses studied .....
   h) Name of correspondence school .....
8. Number of accounts for which you and your firm do work . . . .
9. State the number of 1956 1040 income tax returns filed by you and your firm . . . .
10. State the number of 1956 1065 income tax returns filed by you and your firm . . . .
11. State the number of 1956 1120 income tax returns filed by you and your firm . . . .
12. State the number of 1956 1041 income tax returns filed by you and your firm . . . .
13. State approximately the number of people employed by your clients . . . .
14. How many of your clients were audited by the Internal Revenue during the years . . 1956..... 1955.....
15. Have you ever been employed by the Internal Revenue Service? . . . . . Yes..... No.....

Number of Years . . . .

Signed.....

(It is not absolutely necessary to sign this questionnaire)

conservative side, we have concluded that we prepared a total of 103,635 corporation returns on Form 1120. This number is equivalent to approximately one out of every seven corporation income tax returns filed during 1954 for the year 1953, as shown by the Statistics of Income for 1953, Part 2, being the latest complete report.

"A total of 731,000 corporation income tax returns were filed for 1953.[4] The total tax liability of corporations for 1953 totaled 20 billion dollars. Of the figure of 731,000 a total of 399,264 disclosed net income that was taxable. The difference between 731,000 and 399,264 is reflected in returns of inactive corporations, in returns of no net income shown, and in returns (approximately 10%) that show net income but of a nontaxable nature. If we decrease the number of corporation returns prepared by our members correspondingly, we obtain approximately 60,000 corporation income tax returns with taxable net income.

"The corporation income tax returns of our members resulted in substantial revenue to the Federal Government, although probably not in as high a proportion as in the case of the individual returns prepared on Form 1040. This would seem to be true because most of our members work for small corporations, a large proportion of which do not have substantial net income. For example, Statistics of Income, Part 2, page 11, points out that 46% of the total corporation income tax liability is reported on the 27,000 returns of corporations that, in 1953, had both income and excess profits tax liability.

"Although the income tax derived by the Federal Government from the corporation income tax returns prepared by the noncertified, practicing accountant may be smaller than in some of the other categories of tax returns prepared by him, nevertheless, he is . . . rendering a real service to the Federal Government in that he is preparing almost one out of every seven returns required by law to be filed.

Filing form 1065

"The extensive work of our members in the preparation of partnership returns (Form 1065) is further evidence of the importance of the noncertified, practicing accountant to the collection of revenue by the Federal Government.

"Answers to question 10 received from more than 3,000 members, when extended, show that, as an average per member, they prepared 23 partnership returns for 1956, or a total of 169,050.

"A 1957 publication of the Statistics Division of the Service has partnership returns for its subject. The returns used in preparing this report were syndicates, groups, pools, and other types of unincorporated joint ventures for the calendar year 1953, fiscal years ended in the period July 1953 through June 1954, and part years with the greater part of the accounting period in 1953. This report discloses that a total of 958,591 partnership returns were filed. Of that number 819,681 (85.5%) reported ordinary net income, and 138,910 (14.5%) were returns with no ordinary net income.

"Based on a filing of 23 partnership returns, as an average per member, or a total of 169,050 for the membership of the National Society of Public Accountants, it appears that one out of every nine partnership returns is filed by a noncertified, practicing accountant.

Other taxes

"The noncertified practicing accountant has demonstrated by his work that there is a need for his services, and that he is an integral part of the economy of our country. He does work for a substantial number of individuals, partnerships, corporations, trusts and estates. Additionally, he maintains records and prepares the numerous tax reports and forms for miscellaneous taxes, such as social security, Federal unemployment, and the excise taxes. As a result, his work has a direct bearing on the employees of his principals as well as the principals themselves. His work is far-reaching.

"The noncertified, practicing accountant has made his services available in many communities where no one else dared to set up a business. This fact is most clearly pointed out by the following language of the Supreme Court of Mississippi in *Moore* v. *Grillis*, 39 So. 2d 505, 508, (1949) where it said:

'. . . It is well known that there are few populous cities in Mississippi, and in such centers Certified Public Accountants do, as a matter of business expediency, generally have their offices, in order to cater to a potential clientele of suitable proportion to earn them a satisfactory competence. On the other hand, there are scores and scores of small communities without any Certified Public Accountants, and whose inhabitants have neither the time, the financial ability, nor the need to leave their places of business to travel to the offices of Certified Public Accountants, more or less distant from them, or to bring such accountants to their small village, or town, as the case may be. . . .'

"The principal issue in *Moore* v. *Grillis, supra,* was the constitutionality of a provision in the Mississippi Accountancy Law that would permit only lawyers and Certified Public Accountants to prepare tax returns for compensation. The Mississippi Supreme Court struck down that provision as an arbitrary discrimination between CPAs and other persons, saying it was without reasonable relation to the public welfare and cannot be justified as an exercise of the police power.

"In keeping with the above quotation from the case of *Moore* v. *Grillis*, the Supreme Court of Florida, on May 31, 1957, in the case of *Florida Accountants Association, et al.*, v. *George W. Dandelake, et al.*, pointed out that (as of June 30, 1955) 36 counties of the State of Florida, with a population of 394,299, did not have a certified accountant residing therein, and that, with the exception of 51 accountants who had a certificate, all the remaining ones with a certificate, 700 in number, resided in twelve counties of the state.

"In support of our contention that the noncertified, practicing accountant has an established place in the economy of our country, we think the following language of the Supreme Court of Florida in its opinion on May 31, 1957, in *Florida Accountants Association* v. *Dandelake, supra,* is noteworthy:

'It is common knowledge that, since 1938, the state and national governments have enacted an increasing number of regulatory measures that are most burdensome to the average businessman in the routine operation of a small business. This situation has created a demand for a clerical employee who is not necessarily a Certified Public Accountant but who can render ordinary accounting service to these small businessmen by preparing the numerous forms and otherwise assisting them in completing the paper work now made essential by the myriad regulatory measures referred to above. In most cases a small businessman would find it unnecessary and, indeed, not economically feasible to employ such a clerical employee on a full-time basis, and it has become routine practice for a number of small businesses

to share the time of one such noncertified accountant. . . .'

"In taking judicial notice of the public records of the State of Florida, the court stated in *Florida Accountants Association* v. *Dandelake, supra,* that over 2,000,000 Federal tax returns were filed in Florida in 1956, including over 26,000 corporation income tax returns; that, in the last fiscal year, over 100,000 business and professional occupational licenses were issued in Florida, including 42,000 retail store licenses. Considering the foregoing figures, and the number of accountants with certificates, the court said:

'. . ., it is obvious that the demand for routine accounting service far exceeds the supply. Thus it appears to us that there is a valid field of operation for a noncertified accountant . . . who is entirely capable of dealing with routine accounting matters, which, as noted, is all that most small businesses need or desire. . . .'

"In concluding, in the *Dandelake* case, *supra,* that a person could practice accounting and call himself an accountant, even though not certified by the State Board of Accountancy, the court used the following significant language:

" 'When the needs of small business . . . are superimposed upon the fundamental rights of all citizens to enter into contracts of personal employment and these two factors are weighed against the right of the state, in the exercise of its police power, to regulate the practice of accountancy in the manner here attempted, there can be no doubt as to the direction in which the scales of Justice will swing.' " ☆

TAX AVOIDANCE IS INEVITABLE: BRITISH VERSION

THE CURRENT "revolt against taxes" includes some of the always-present resentment that one can't take advantage of all the loopholes he hears about others using. This resentment is a potentially dangerous force, and it needs to be understood better by taxpayers. *The Economist* (London) had a few paragraphs recently that stated the facts well, thus:

Tax avoidance . . . is the result of high taxation, rather than its cause. Emotional resentment against people who, by some rearrangement of their affairs, seem to be paying less than their "fair" share is easy to arouse. But no tax system has ever achieved natural justice in the distribution of the burden between different taxpayers in different circumstances. Nor can it be asserted as a matter of moral principle that a man has a duty not to alter the disposition of his affairs in order to save tax. If the state imposes a maximum personal rate of 92½ per cent it cannot complain if some of its citizens have a propensity for leisure after working a three or four day week.

The problems of definition of avoidance are formidable. The happy couple who choose to be married on the 5th, rather than on the 6th, of April are clearly guilty of avoidance. What of the self-employed man who at last has the opportunity of avoiding tax by paying a retirement benefits premium? No one would criticize a householder who makes a maintenance claim to save Schedule A, but what about the owner of two companies, one successful and the other unsuccessful, who marries them so that subvention relief may save Schedule D? Opinion, moreover, changes with the passage of time. Thirty years ago many thought it near the knuckle to make charitable subscriptions under covenant; now it is thought uncharitable not to do so.

Indiscriminate criticism of tax avoidance leads to some strange contradictions. Should a wealthy taxpayer refuse to buy the maximum holding of National Savings or Tax Reserve certificates because, by reason of their tax privileges, they offer the equivalent of gross yields of 56 and 40% respectively? Is an industrialist to retain inefficient boiler plant because the installation of fuel saving equipment would bring him a 20% subsidy on his capital expenditure? Should a farmer refuse to modernize his laborers' cottages on the ground that the agricultural capital allowance is extravagant? To crown it all, should a board of directors keep dividends down to avoid paying profits tax at the higher rate?

Fulmination about tax avoidance is not enough. Criticism of citizens who do what the law permits has no value. If Parliament considers that a course of action is wrong, it can legislate against it; indeed it does so increasingly. Tax avoidance must bear its full share of the responsibility for the erosion of the tax base, but any attempt to stop it by direct action is doomed to failure. At best it will merely plug holes. The root causes of avoidance are the high marginal rates of tax that inevitably result when attempts are made to produce a quart of tax out of a pint pot of income and to drive egalitarianism to excess. ☆

Lawyers, accountants set fee schedules for tax work

WE FIGURE that all tax practitioners are interested in what rates their colleagues charge. This month we ran across two measures from widely separated areas: one is for accountants, the other for lawyers.

The State Bar of Wisconsin Board of Governors adopted a schedule of minimum fees in September, 1957. Under the minimum fees for consultation and office work, they listed "income tax returns, per hour $15."

The Idaho CPAs ran a survey of source of fees and rates charged by CPA firms for different kinds of work done by different grades of people. We don't have the full survey; apparently it covered members, but we don't know the number or portion of total membership responding. The survey reports that overall, 30% of total fee income came from tax work (it ranged from 10% to 60% of work done). It also reported rates (dollars per hour) charged to clients for tax work done by principals, senior accountants and junior accountants classified by the size of the firm (which apparently means total accounting personnel, partners and employees). See adjoining box.

Size of firm:	*One*	*2-5*	*5-10*	*over 10*	*overall average*
Principals	6.90	9.21	11.81	12.50	9.51
Senior accountants	—	8.12	9.81	11.00	9.38
Junior accountants	—	5.58	6.50	7.87	6.27

TAX PLANNING AND
Business management
EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

CA-7 opinion in Pelton Steel clouds rules on surplus accumulation, redemption

by DALE SORDEN

Tax men who hoped for clarification of the Tax Court's rule in Pelton Steel on unreasonable surplus accumulation and stock retirement are disappointed by the Seventh Circuit's opinion, which does little more than affirm the Tax Court decision. The appellate decision leaves grave doubts as to how future transactions should be handled. Mr. Sorden, a Milwaukee attorney, sums up the disturbing situation left by the Seventh Circuit's opinion. This article is based on a talk before the Wisconsin State Bar Association.

PRACTITIONERS who hoped that the review of *Pelton Steel*[1] by the Court would result at least in clarification if not in reversal saw their hopes frustrated by the affirming opinion by the appellate court.[2]

Taxpayer-corporation had three shareholders, E, F and S. E and F, controlling 80% of its stock, desired to sell out and conducted an extensive search for a buyer. S, the principal operating officer, did not want the corporation to come under the control of outsiders[3] and in connection with prospective lenders worked out a plan (suggested by the banker) whereby the corporation would redeem the stock held by E and F for the price they were asking from outsiders, paying $800,000 in cash and $400,000 in preferred stock. Of the cash, $500,000 was borrowed; the remainder came from earnings and surplus, including $200,000 of earnings during 1946, the year in question. No dividends were paid during 1946, both to preserve cash for the planned redemption and because payment of a dividend would have made impossible the contemplated borrowings which were essential to the redemption.

The company followed the new procedure under Section 534 to shift to the Commissioner the burden of proof on whether earnings and profits were accumulated beyond the reasonable needs of the business.

The Tax Court held that unreasonable accumulation is merely one basis for finding that a corporation is availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of permitting earnings or profits to accumulate and that a corporation may be found to have been so "availed of" even in the absence of a finding that the accumulations were beyond the reasonable needs of the business. The Tax Court then found that Pelton had been so "availed of," that the Section 534 procedure did not shift the burden of proof on this ultimate issue and that even if, in this case, the reasonableness of the accumulations were significant and the burden on that issue had been shifted, the planned redemption did not represent a reasonable need of the business.

The more frequently and closely one reads the opinion of the Court of Appeals, the more difficult it is to determine just what it was that the court did decide, other than that it decided to affirm the Tax Court. It quotes as "an interesting sidelight" the Tax Court's notation that *if* the entire 1946 profits had been distributed as a dividend, E, the controlling shareholder, would have paid $102,000 more in personal income taxes for that year, and that instead he paid $150,000 in alternative capital gains taxes in the next year when his stock was redeemed. It notes the requirement that the Tax Court's findings of fact cannot be set aside "unless clearly erroneous." It emphasizes that the redemption plan required and had unanimous stockholder approval and distinguishes *Dill*[4] and *Gazette Publishing*[5] on the grounds that in those cases it was a minority which was bought out instead of, as in *Pelton*, the majority. The opinion contains no discussion of the significance of any of these points.

Neither does the opinion make any reference to the effect or lack of effect of the shifting of the burden-of-proof rules under the new Section 534 procedure, although this was the first case tried under the amendments and the application and effect of the amendments was one of the major issues presented to both courts.

From a planning standpoint, it is difficult if not impossible to see any bounds to the *Pelton Steel* doctrine. It is undisputed that the majority shareholders had both the power and the desire to sell control of the corporation to outsiders and thus end its independent existence, and that the purpose of the reorganization and of the failure to pay dividends in 1946 was to prevent this. The finding of the Tax Court, quoted in part in the opinion of the Court of Appeals, was that the impetus for the plan came from the minority shareholder S, and grew out of his concern over the possible loss of the corporate "personality" if the sale to outsiders were consummated. The minimum characterization of the case must therefore be that an accumulation to redeem stock for the purpose of preserving the independent existence and "personality" of a corporation is an "improper" accumulation which will cause the corporation to be considered as

[1] Pelton Steel Casting Co., 28 TC 153.
[2] — F.2d — 58-1 USTC ¶9179 (CA-7, 1758).
[3] The courts commented, "Slichter, who had made petitioner his life's work—developing close personal contacts with its customers and becoming largely responsible . . . for employee relations—was very concerned that petitioner might become a 'captive foundry' . . . . He was also concerned about the attendant changes in the nature of its business . . . as well as the possibly deleterious effects on employee relations and the status of 'key men' in the organization as it existed. Slichter did not like the idea of petitioner's becoming a subsidiary of some out-of-town corporation and of having his employee policies interfered with."
[4] Dill Manufacturing Co. v. Commissioner, 39 BTA 1023.
[5] Gazette Publishing Co. v. Self, 103 F.Supp. 779 (D.C. Ark. 1952).
[6] We understand an application for certiorari is about to be filed with the Supreme Court.

having been "availed of" for surtax avoidance. The fact that the payment of dividends would have increased the surtaxes of the majority shareholders is certainly not a distinguishing feature since that is true in any case where less than 100% of earnings are paid out in dividends. Further reliance on the *Dill* and *Gazette* cases would also seem dangerous, notwithstanding the majority-minority difference, since the decision to pay dividends and/or redeem stock always rests with the majority.

While the opinions of both courts seem to infer that it was E, the majority shareholder, who had the proscribed desire to avoid surtaxes, the result of the decisions is that S, the minority shareholder, bears the economic burden of the penalty surtax.

Since it was argued that the tax applies only where there is accumulation *instead* of distribution and that in *Pelton* the accumulation was purely temporary and for the express purpose of making a distribution, it would appear unsafe to attempt to distinguish *Pelton* in any case where the contemplated distribution is not to be in the form of an ordinary dividend.

Unless *Pelton Steel* is reversed either by the Supreme Court[6] or by Congress, or until it has been eroded by a considerable body of subsequent decisions, it is doubtful that any plan for stock retirement by a company which fails to distribute 100% of its earnings in the form of taxable dividends may safely be approved by practitioners without a specific official ruling. ☆

NEW EXCESS PROFIT TAX DECISIONS

Corporation may use base period experience of predecessor proprietorship. In 1949 taxpayer was incorporated. The sole stockholder transferred most of the assets of his construction business but retained some cash and 12 incompleted contracts. Reversing the Tax Court, this court holds the corporation was an "acquiring corporation" because it acquired "substantially all the properties" of the proprietorship. The cash transferred was sufficient for its operations; the contracts held by the proprietor had been substantially completed. Accordingly, taxpayer may use the base period experience of the proprietorship in computing its Korean excess profits tax. It is immaterial that the transfer of assets for stock was in the form of a sale. *J. M. Turner & Co.*, CA-4, 7/17/57.

Entire payment for retirement of stock includible in daily capital reduction; relief for branch loss denied. Taxpayer purchased and retired 4,725 shares of its common stock for $1,500,000. For purposes of computing daily capital reductions for the taxable year 1950 under the provisions of the Excess Profits Tax Act of 1950, the court holds the cost of the stock is under the circumstances here not equivalent to a dividend and is to be treated as a distribution made during the taxable year *not* out of earnings and profits. The court also denied taxpayer an adjustment in its base period net income for losses from the operation of a farm as a branch. After the court modified the farm losses by the correct amount of executive salaries, office expenses, and interest, the net losses were not shown to have exceeded the statutory test for relief—15% of the aggregate base period net income. *Mid-Southern Foundation*, 28 TC No. 102.

Lace manufacturer denied relief under "push-back" rule. A lace manufacturer claimed EPT relief on the grounds that if it had increased its capacity two years earlier than it actually did, its base period production would have been higher. The court denies the relief, finding that the manufacturer's reconstructed figures failed to reach a constructive average base period net income great enough to justify any relief. *Liberty Fabrics of New York, Inc.*, 28 TC No. 70.

Regulations invalid in limiting EPT accrual election if installment receivables were sold [*Acquiescence*]. Taxpayers are transferees of Dixie Shops, Inc., which was held entitled to elect to compute income from installment sales on an accrual basis under Section 736(a) of the 1939 Code for purposes of reporting its excess-profits-tax liability. This relief was allowed by the Code if installment receivables at the beginning of the year were 125% of those at the end. The Regulations required the inclusion in accounts receivable outstanding at the end of the year accounts which previously were sold. This provision is, the court held, invalid, at least insofar as this taxpayer did not sell the accounts to meet the test but because it was closing the store where they arose and would be unable to collect efficiently. The IRS acquiesces in result only; while disagreeing with treatment, it will not file an appeal. *Selma Berry Trust*, 26 TC 344. *acq.* IRB 1957-23.

No change in business; design improvements in product were routine. The Tax Court holds that taxpayer made no change in the character of its business during the base period sufficient to entitle it to 722 relief. Changes in its agricultural implements line were routine design improvements. Though its metal-forming hydraulic presses might be considered new, an increase in income due to that change was, it holds, not proved. *A. B. Farquhar*, 28 TC No. 83.

722 relief denied; increase in net income not related to increased capacity. Although taxpayer demonstrated that it increased its capacity for the production of castings during the base period, it failed to show that such increase actually (or if it had occurred two years earlier would have) resulted in an increased level of base period net income. The court therefore holds taxpayer is not entitled to Section 722 relief. *Fanner Mfg. Co.*, 29 TC No. 65.

EPT invested capital in 1925 consolidation included positive and negative goodwill. [*Certiorari denied*]. In 1925, many companies merged to form taxpayer. Its invested capital for excess profits tax is computed by determining the value of property paid in for its stock; that property is the stock of the merged companies. In the absence of market values for the stock, the Commissioner valued the assets of each. He computed goodwill by capitalizing at 20% the excess earnings of companies earning more than 10% on their capital. This amounted to about $3.2 million. However, for companies which earned less than 10%, he computed a "negative" goodwill, i.e., the amount by which the assets exceeded ten times the earnings. In total, this discount amounted to $2.2 million. He therefore allowed only $1 million goodwill. The Court of Claims agreed. In effect, the Commissioner compared total earnings of all companies with total assets of all companies and computed the merged goodwill. This method is fair. *General Outdoor Advertising Co., cert den.*, 12/9/57.

NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Senator Kennedy proposes Federal fixing of unemployment benefit maximums

ON FEBRUARY 6 Senator Kennedy of Massachusetts introduced Senate Bill 3244, identified as "The Unemployment Compensation Act of 1958."

This bill is intended to make substantial changes in the Federal unemployment insurance law and by setting up numerous standards, would require many amendments to the unemployment insurance laws in all states. This measure was co-sponsored by nine other Democratic Senators and has been referred to the Senate Finance Committee. A companion measure was introduced by Congressman McCarthy of Minnesota.

In introducing the bill Senator Kennedy stated in part:

"The Federal-State jobless insurance program was designed to meet the loss of purchasing power by providing benefits to workers sufficient in amount and duration to enable them to maintain decent living standards and pay their necessary bills until new work could be found. This protected not only the worker but his grocer, his landlord and the other merchants dependent upon him for their own livelihood. Today this restoration of purchasing power in the local business community is a key to meeting effectively the recession that threatens our economy."

We are indebted to Mahlon Eubank, Counsel to the Social Security Department of the Commerce and Industry Association of New York for the following analysis of the proposed legislation.

Changes in benefits

The maximum benefit for each state would be set at two-thirds of the state's average weekly wage computed on July 1 of each year. The weekly benefit amount for each claimant would be at least one-half of the individual's average weekly wage. All benefits would be payable for a uniform duration of 39 weeks.

Federal standards are set out for defining a benefit year, base period, average weekly wage and entitlement.

Extension of coverage

The bill provides that coverage would be applied to employers of one or more employees at any time. It includes in coverage agent-drivers for most types of services (except milk), full-time life insurance salesmen, home workers if their work is subject to state's licensing laws, and most full-time traveling or city salesmen.

Disqualification provisions

The bill provides that no claimant should be disqualified for more than four weeks immediately following the week that the claimant (a) left suitable work without good cause, (b) refused to accept suitable work without good cause, or (c) was discharged for misconduct in connection with his work.

The bill provides a maximum disqualification for four weeks where there is a stoppage of work but only if the claimant was directly interested in such stoppage or was of the same grade or class of employee as those on strike. No disqualification at all is imposed if the claimant's employer fails to conform to Federal or state laws pertaining to collective bargaining, wages, hours or conditions of work.

A detailed definition of "suitable" work says that "work shall not be deemed suitable for any individual if the availability of the work is due directly to a strike, lockout, or other labor dispute at the place where such work is available"; or if the "wage rate, weekly earnings, hours or other conditions of work are substantially less favorable than those prevailing for similar work in the locality," or if, as a condition, an individual must join a "company union" or resign from or refrain from joining a bona fide union.

Temporary or emergency benefits

The bill provides something in the nature of temporary or emergency Federal benefits as a means of bridging the time between adoption by Congress and the enactment of required changes in state law. Kennedy's explanation is:

The standards provided in the bill are to be effective July 1, 1959, allowing a sufficient period for all state legislatures to meet and enact necessary amendments to state laws. In order to meet the immediate unemployment situation, however, benefits will be paid, for a period from 60 days after passage to July 1, 1959, at levels up to the benefit standards—with the Federal Government bearing the cost of such excess benefits.

The bill sets up a reinsurance fund and provides a contingency fund for administrative expenses to aid states whose unemployment compensation coffers are hard hit by unemployment. Kennedy's statement emphasizes that no increase in the present 3% unemployment tax maximum would be required in order to finance these proposed improvements. ☆

IRS to rule on various personnel matters

PERHAPS AS an aftermath of the criticism of IRS personnel policies by the Mills Subcommittee on Internal Revenue Taxation last year, the Service has been working at improving its personnel procedures. The personnel director, Amos Latham, has had approved programs setting forth the avenues of promotion for technical people (agents, technical advisors, etc.). Moreover, the Civil Service Commission classification for many technical jobs has been revised; more of these categories have been moved up into higher-pay, higher-experience levels. This change should make it easier for the IRS to get competent people for its tough jobs.

For 1958 the IRS is moving over to its housekeeping divisions, and hopes to do a similar job for cashiers, returns processors, etc.

Other areas in which the IRS hopes soon to establish policy are disciplinary actions, outside employment, rules of conduct and performance ratings. ☆

CLASSIFIED ADVERTISING

Classified advertising will be accepted for publication for help wanted, situations wanted, business opportunities, practices for purchase or sale, purchase and sale of merchandise, and similar items. Rate per insertion: 60¢ per line, minimum, $3. Address copy for advertisement, together with check, to The Journal of Taxation, 147 East 50th Street, New York 22. Replies should also be sent to this address.

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Tax Attorney, Ivy League graduate, thoroughly experienced in all phases of taxation, desires per diem work in New York City area. Box 138.

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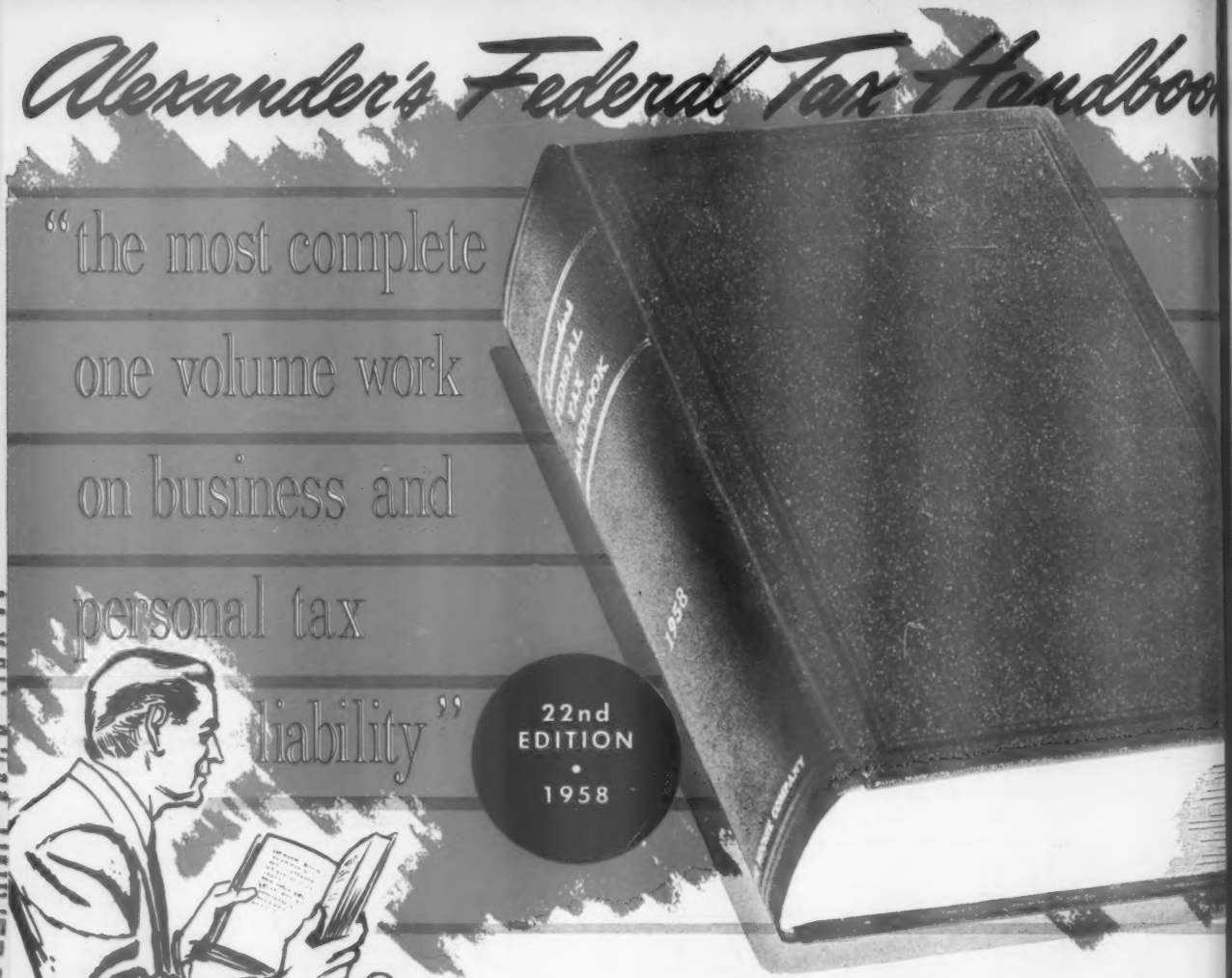

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